AN EXAMINATION OF HOW ENTREPRENEURS CAN IMPROVE THEIR POSITION IN RELATION TO INVESTORS

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An Examination of How Entrepreneurs Can Improve Their Position in Relation to Investors

Key words: Venture capital, entrepreneurship, business angel, corporate venture capital

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I would like to begin by saying that it has definitely been an interesting journey. I started out as a full time PhD student in 2003, enrolling at Hanken full of ideas and questions that I wanted to resolve. Finally, in 2011, I am finishing my thesis. I think that I have answered at least some of the questions but a fair few remain unanswered. I hope that while reading my thesis you will be excited by entrepreneurs, entrepreneurship and entrepreneurial finance. I genuinely believe that innovative and motivated entrepreneurs will have a great impact on the future of western economies. An effective relationship with investors is an essential element that growth oriented entrepreneurs need to master.

I am greatly indebted to many people in reaching the end of my journey. First, I would like to express my gratitude to those countless numbers of people from my department and amongst my family, friends, neighbours, relatives, colleagues and business acquaintances who have over the years enquired how my research project is going. To be honest, I haven’t heard that question so often of late. I think that either they have forgotten about the whole thing or simply lost hope! Anyway, thank you, it was really good that you kept reminding me or you probably wouldn’t be reading my thesis today.

During my journey I have had the pleasure of working with, conducting research together with, debating, acting as an opponent to, interviewing, and debating with, again, with more people than I can recount. So, thank you all. Especially I would like to mention Harry Sapienza from the University of Minnesota for your support and inspiration. Tom Lahti from Hanken for great conversations related to entrepreneurship, and for your advice. Martin Lindell, my supervisor at Hanken, for letting me follow my own path. And thank you all Floosters. It has been a pleasure to conduct research at Hanken.

Without question, my utmost and greatest thanks go to my wife. You have been unbelievably supportive during the entire research project. You moved with me to two different continents (United States and in Singapore), have commented on and proofed my articles, taken care of our children and frankly of me, too! Thank you Anna!

Sundsberg, 23rd August 2011

Oskari Lehtonen
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1 INTRODUCTION

This thesis concentrates on the entrepreneurial risk finance known as venture capital. A vast number of successful companies such as Hotmail, Microsoft, Apple, Federal Express and Intel in the U.S. (de Bettignies & Brander, 2007; Livingston, 2007) and companies such as MySQL, Digia, Tiimari, Tokmanni, Lumene and Videofirma Makuuni in Finland are or have been backed by venture capitalists at some point in their development. The Finnish welfare system is becoming more dependent on high growth entrepreneurs as their efforts are required to provide economic growth, employment and tax revenue. High growth entrepreneurship requires flexible funding mechanisms and venture capital funding is one of the most suitable methods to finance growth oriented firms. Therefore, understanding and effectively utilizing venture capital funding could have a high impact on the entire Finnish welfare system. While we are “searching for a new Nokia”, a great deal of funding has been required and allocated to innovative growth companies (Alkio, 2009). However, funding is only one element of venture capital investing. By better understanding the venture capital funding process and value creating mechanisms we may be able to earn better results from these activities. This would benefit entrepreneurs, venture capital firms, their employees and the entire Finnish economy.

Venture capital has attracted growing academic interest during the last twenty years and, due to the extensiveness of the entrepreneurial literature, I wanted to try something new in my thesis. I utilised methods and approaches that could reveal something novel and provide benefits in the long run. As Professor Robert Blackburn said in Rent XXII in 2009, “what we need in entrepreneurial research is not always new theories but new information.” Of course a thesis should contain and be based on solid theoretical argumentation and grounds, not just provide new information. Consequently, I believe that Professor Blackburn is right in warning us not to “over-theorise” everything that we do in academic research and I believe that it is especially important to provide insightful understanding that has real value for both academics and practitioners.

Entrepreneurs encounter various problems and challenges while interacting with investors, both prior to the point in time when they have actually ensured that they will get funding (also called the pre-investment phase) and during the investment period when entrepreneurs and investors work together (also called the post-investment phase). These phases have several interdependencies (see e.g. Cable & Shane, 1993), which makes it even more important for entrepreneurs to understand what they are committing to before it is too late. Figure 1 presents the entrepreneurs’ key challenges both prior to the relationship being formed and afterwards are.

1 Not all the mentioned companies are examples of successful venture capital investments but they demonstrate that brands that we see every day are backed by venture capitalists.
2 In the thesis I use the term “Investor” to describe either venture capitalists (VCs), business angels (BAs) or corporate venture capitalists (CVCs). I may use the term also when I mean all three sources of risk funding for entrepreneurs or I may only concentrate on one or two sources of those. When relevant, I specifically emphasise which source of funding is in question. In article ONE the main differences and similarities of the funding sources and their consequences and implications are discussed. See also table 8 where I report what data I have used in the Articles. For example, corporate venture capital data is especially limited in this thesis. Only a few case companies in article TWO had CVC funding. The issue of using data from one form of investor group (i.e. VC, CVC or BE) and broadening it to cover other sources has been discussed in limitations phase 7.1.).
Main challenges for entrepreneurs

- time consuming to find investor
- difficult to convince investor
- harsh contract covenants
- a few alternatives
- risk of replacement
- investors veto rights
- strategy disputes
- reporting requirements

Figure 1  Entrepreneurs’ main challenges prior to a relationship being formed and after.

I have selected the entrepreneurs’ point of view for my thesis. I argue that since there is not one correct or well established method for agreeing on matters between entrepreneurs and investors, there is always room for negotiation. This, in turn, means that the better the entrepreneur is prepared for the negotiations and the better their understanding of investors’ individual operating practices, motives, reward schemes, and other relevant issues, the more likely is that entrepreneurs will negotiate themselves suitable deals.

One way to illustrate the situation is to compare venture capital investment negotiations with employment negotiations. The potential employee has at least a fairly good idea of what constitutes excellent, acceptable and bad terms that he or she should or should not accept while agreeing on a new employment contract. In venture capital investment negotiations there are rarely such guidelines 3. Therefore, it might be challenging for entrepreneurs to negotiate good deals with very experienced investors. A quote from one venture capitalist (Cardis et al., 2001, p. 77) illustrates how far apart the parties can sometimes be:

“We went to visit a company and they had this great high-speed computer. As we were riding back home – and they were supposed to come back to us for the proposition – I said to our guys: “Okay, let’s have a little pool here. What valuation do you think they’re going to come back to us with?” And we went from $100 to $250 million, all the time saying there was only a 50 percent chance that it would work. But if it does work, it would be worth that valuation. They came back with $4 billion.”

Valuation is, however, only one crucial aspect of investors’ and entrepreneurs’ negotiations. There are various other potentially dangerous and risky contract

---

3 There are, however, associations and organizations that publish annual statistics of VC investments (in Finland FVCA). They could provide some indicative answers about adequate invest sums, ownership percentages and valuation (the two latter ones are not reported by FVCA). However, entrepreneurial risk financing and contracting contains much more that just negotiating about valuation and ownership percentages (Ehrlich et al., 1994).
covenants, and the delivery of appropriate value added for entrepreneurs is another very important element for entrepreneurs. Therefore, if we are able to provide more information on VCs' operating procedures, and highlight potential risks and benefits, the better the chance that entrepreneurs will make a good deal with investors. In the Finnish venture capital market, where there are not so many investors, it is even more important that entrepreneurs take the correct approach when they negotiate and interact with investors. If those few investors provide a negative answer for an entrepreneur, there are very few alternatives to contact.

There are three key characteristics that make this research area and my thesis particularly interesting and relevant. First, entrepreneurs are, by definition, good at what they do; namely developing business (since without that assumption there is no chance of acquiring VC funding), (Ucbasaran et al., 2009). Investors and especially VCs are, however, professional dealmakers. Due to their experience, there is almost always asymmetry between these parties. Investors are able to draft better contracts, benefit more from the relationship or at least ensure that their risks are better hedged than those of the entrepreneurs. In addition, an investor’s risk profile is very different from an entrepreneur’s. VCs, for example, commonly have a portfolio of firms and their investments are, therefore, better diversified (Manigart et al., 2002). Hence, fresh ideas and support are greatly needed from the entrepreneurs’ point of view as well. From a theoretical point of view, the notion described above means that it might be in an entrepreneur’s interest to bring in outside resources to diminish the “knowledge gap” between investors and entrepreneurs (resource based view).

Second, a somewhat overlapping fact is that early-stage entrepreneurs are not that experienced and they may often need support in a variety of areas (potentially e.g. in general management, marketing, sales) in addition to the funding (Barney, et al. 1996). I acknowledge that a link between entrepreneurial experience and a subsequent venture’s performance is still open to debate (Hellman & Puri, 2002; Kelly & Hay, 2003). However, since investors continuously interact with a broad range of entrepreneurs, I assume that it is likely that investors have more experience regarding similar challenges and problems. In sum, investors should have the experience and knowledge to support entrepreneurs in various problems and challenges that they encounter while they are developing their venture. These investors’ “best practices” should increase the venture’s likelihood of higher growth and/or decrease the likelihood of failure. So, what are the means (before committing to a relationship and during the relationship) that entrepreneurs could utilise to ensure that investors will actually provide the required support? This question is crucial not just from the entrepreneurs’ but also from the economy’s perspective – if the ventures really succeed.

---

4 E.g. what happens to proceeds (liquidation preference), what happens to entrepreneurs’ shares if he/she resigns or gets fired (vesting), who appoints a board, who decides about mergers and acquisitions and other similar transactions (tag-along, drag-along rights), do investors have a veto related to major decisions and how much salary do the entrepreneurs receive?

5 “A good deal” could mean, for example, that entrepreneurs will get timely support from investors, they have to give away as little equity as possible or get major capital investment from investors by giving away a certain ownership share and entrepreneurs don’t expose themselves to harsh contract covenants.

6 In early stage funding in Finland, the most established actor is government backed venture capitalist Vera Venture (www.veraventure.fi). The same organization is also responsible for running a business angel network called InvestorExtra (SijoittajaExtra in Finnish). Therefore, when an entrepreneur fails to convince Vera Venture representatives it is very difficult to get either early stage VC funding or access business angels. For series A-funding the situation is fairly similar. There are only a few VCs that provide series A funding in Finland.

7 See e.g. Elango et al. (1995) or Franke et al. (2008) about how difficult it is to get VC funding.
they can provide increased benefits for the economy and society. Experienced investors that devote their resources to development may have a crucial impact on strengthening the growth process of entrepreneurial firms (Fitza et al., 2009). Theoretical concepts and frameworks, such as the role of trust (procedural justice theory) and allocation and entrepreneurial methods to ensure the acquisition of optimal resources (resource based view) are closely related to this notion.

Third, entrepreneurs that have high growth aspirations commonly do not have realistic financing sources other than some form of private equity investor. For example, banks do not provide funding without collateral (see e.g. Brewer & Genay, 1994; McNally, 1995; Brewer et al., 1997). Therefore, VC funding impacts a wide range of firms that have a particularly high chance of growing and becoming larger firms that will then, in turn, provide jobs and bring other positive effects to the economy. As mentioned earlier, firms such as Intel, Apple, Hotmail, Microsoft, and Federal Express all raised VC funding in their early phases (Fried et al., 1998). According to the Finnish Venture Capital Association (FVCA) during 2010 its members invested in 222 firms, of which 150 were early stage firms. It has been shown that small firms that receive VC funding contain high growth and job creation potential (see e.g. Davila et al., 2003). The vital question is how can we strengthen and ensure that this growth really happens? One would assume that both entrepreneurs and investors have similar interests that should ensure cooperative behaviour and positive relationships. This should, in turn, ensure that both parties accomplish activities that are best for the venture and ensure the growth of the venture and positive side effects for the economy (Audretsch & Thurik, 2000). However, this is not always the case, VCs, for example, commonly have a large portfolio of firms that they manage simultaneously, and they allocate their limited resources accordingly. The allocation of the resources might be totally different from those which a single entrepreneur requires and expects. Therefore, the potential positive consequences for individual firms or the economy do not always materialise. The same may apply to CVCs (corporate venture capitalists) and somewhat to BAs as well. From a theoretical perspective, the relationship between investors and entrepreneurs relates to concepts such as agency theory (hierarchical relationship), procedural justice theory (role of trust in the relationship), resources and different power constructs.

In sum, when evaluating the relationship between entrepreneurs and investors, the operating model includes the following aspects i) there is information asymmetry between parties, and ii) from an individual entrepreneur’s point of view it may be difficult to ensure the best possible outcome of the relationship. Finally, iii) there are very few alternatives for venture capital funding from the perspective of a growth oriented firm that requires capital. Therefore, it is no surprise that several scholars have called for more research from the entrepreneurs’ perspective in this setting (see e.g. Arthurs & Busenitz, 2003). From my perspective, the challenges in Finland facing entrepreneurs in dealing with investors, the lack of substitutes for VC funding, and the substantial economic importance of VC funded companies, have been great motivators in focusing my thesis on these issues.

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8 This data was retrieved from www.evca.eu’s and www.fvca.fi website on 17th of March 2011.
9 It has been suggested that VCs contribute more of their time when entrepreneurs face some serious problems (see e.g. Fredriksen et al., 1997 and Cornelius & Naqi, 2002).
1.1. Aim of the thesis

As explained above there is a clear need to better understand the relationship between entrepreneurs and investors and the antecedents that set that relationship. The stakeholders that will benefit most from this thesis are entrepreneurs (who will be more able to draft better contracts and/or get more value added from investors) and the entire economy (in the form of high growth ventures that are likely to create tax revenue and employment). Having said that, a high level aim of the thesis is to improve the position of entrepreneurs in relation to venture capitalists and other risk financing sources (i.e. business angels and corporate venture capitalists) both before and after entrepreneurs have committed to a relationship. I have used the term “position” deliberately due to the fact that it is more general than, for example, “benefit”, “reward” or “return”. Position includes both financial benefits that entrepreneurs could gain e.g. by negotiation and the signing of better investment agreements, liabilities that they do not expose themselves to by writing the same contracts. Position also includes other potential benefits that entrepreneurs may gain while doing day-to-day business with investors. Lastly, it could mean that entrepreneurs actually choose a more suitable investor for their individual needs (e.g. because their individual chemistry is good, the fit between investor and entrepreneur is positive and the delivery of nonfinancial resources between the parties is possible (Murray & Wright, 1996; De Clercq et al., 2006).

1.2. Structure of the thesis and the key findings

In order to provide answers and insights and fulfill the thesis’ aim (to improve the position of entrepreneurs in relation to venture capitalists and other risk financing sources (i.e. business angels and corporate venture capitalists) both before and after entrepreneurs have committed to a relationship) I have reviewed the extant literature and utilised my experience of working as an entrepreneur with investors (chapters 2 and 3). Consequently, I have identified research gaps that are significant and relevant for the thesis’ aim (chapters 4. and 5.). After identification, I have utilised best the possible methods and approaches, according to my resources and the data (realistically) available, in order to provide answers, suggestions and proposals for the research gaps10 (chapters 5. and 7.). I believe that these aspects that I have concentrated on will attract considerably more attention in the future (e.g. the role of advisors, certification, power in investor-entrepreneur relationships and the selection of investors).

From a theoretical point of view, frameworks and theories that have been utilised in an investor-entrepreneur relationship have commonly suggested that the relationship is fairly linear and they have concentrated on only one or a few elements of the relationship. For example, agency theory suggests that entrepreneurs are agents and investors principals, procedural justice theory emphasises fairness and trust in the relationship, the resource based view concentrates on resources and the complementarity of resources. However, I argue that in practice the relationship is much more complex and very dynamic in nature. This observation of entrepreneurial practice has motivated me to try out something somewhat different in my thesis in terms of data, methods and approaches.

10 Note that in Article THREE I had a more “grounded theory approach” (Yin, 2003). In other words, I was not sure what the end result of the research project would be when I started observing the entrepreneurs. “I lead the data to lead me.”
In figure 2 I have illustrated how my research project developed from my initial notion 
that the entrepreneur-investor relationship is problematic and not always balanced in 
various academic research projects (the articles) and the thesis.

<table>
<thead>
<tr>
<th>Practical analysis:</th>
<th>Investors’ and entrepreneurs’ relationship is sometimes problematic and unbalanced. What can we do?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Review of literature:</td>
<td>Various theories and frameworks have been utilized but no clear understanding nor best practices have been developed. → new approach is needed!</td>
</tr>
<tr>
<td>Identification of relevant research gaps:</td>
<td>based on literature and practice (own experience and interviews with industry experts).</td>
</tr>
<tr>
<td>Design of research project(s):</td>
<td>Detail analysis of the various theories and existing research. Design of individual research projects accordingly.</td>
</tr>
<tr>
<td>Execution of research project(s):</td>
<td>Various methods, data and approaches were utilized in order to find answers and insights.</td>
</tr>
<tr>
<td>After analysis:</td>
<td>Insights for practise, theory and future research.</td>
</tr>
</tbody>
</table>

**Figure 2  Evolution of the Articles.**

My thesis consists of five articles that have their individual aims, research questions 
that they are seeking answers to, data and theoretical backgrounds. In particular, 
Articles TWO, THREE, FOUR and FIVE have all started from the identification of a 
research gap that has both theoretical and practical relevance in the extant literature. 
Article ONE is a literature review that summarises what we already know about venture 
capital, business angels and corporate venture capital investing. Therefore, it does not 
contain a critical review of the literature, nor does it identify of research gaps. It 
functions as an introduction to the subject of the thesis.

In Article TWO, the main aim has been to study how entrepreneurs select investors, 
identify factors that influence entrepreneurs’ decisions and the consequences of the 
investor selection. Commonly researchers have been mainly interested in VC’s decision 
criteria about entrepreneurs\(^{11}\). More specifically, the key research questions are what 
are the reasons that led to the selection of that particular VC or syndication of VCs? And 2) is there a positive association between an entrepreneur's pre-investment selection process and the post-investment VC-entrepreneur relationship? In Article THREE, the aim is to utilise power constructs (dependency, power balance/imbalance, power

\(^{11}\) Existing research has identified for example the following VCs’ decision criteria: the entrepreneur’s industry experience, education (Shepherd, 1999), new venture experience, strategy focus (Shrader et al., 1997), the entrepreneur’s general characteristics, target market, product or service portfolio, the leadership potential of the lead entrepreneur and the management team (Muzyka et al., 1996).
sources) and study their applicability in investor-entrepreneur relationships. The Article searches for answers to three research questions: i) Is it so that investors are more often the more powerful party in the relationship? ii) How does power and the balance of power influence the transfer of nonfinancial benefits and co-operation between the parties? iii) What are the parties’ power sources and do they vary according to the situation? In Article FOUR, we have identified an earlier disregarded actor “the advisors” in the investor-entrepreneur setting. The aim has been to study the role of advisors in the venture capital investment process. The Article answers the following two research questions: ii) How do advisory firms operate? ii) What are the benefits and disadvantages of employing advisors for entrepreneurs who are looking to acquire VC funding? Finally, in Article FIVE the aim is to study the investors’ certification effect on early stage firms. More specifically the Article searches for answers to two research questions: i) Does a VC’s investment certify portfolio firms (i.e. does a portfolio firm receive increased media attention after the investment event). ii) What is the content of media attention on a VC’s portfolio firms. In addition to these four Articles that contain data, I participated in a research group that wrote an article on entrepreneurial financing (Article ONE). The main target of this Article was to sum up what we know about venture capital funding (including business angels and corporate venture capitalists).

One method of presenting the Articles that form this thesis is by using the VC cycle approach (Tyebjee & Bruno, 1984). The VC cycle illustrates how the investor-entrepreneur relationship develops from its first meeting into a relationship and eventual exit. In figure 3 I have plotted my Articles next to the VC cycle in order to illustrate which phase of the cycle they mainly relate to.

---

12 See from the article’s literature review that only a few very isolated papers have been published on the subject. However, our paper (the paper is co-authored with Lahti) was the first paper that shed light on the advisors’ operating procedures and the benefits that they could provide for entrepreneurs.

13 One of the objectives of writing the article was to provide an up-to-date and consistent synthesis of what we know about VC funding for U.S. MBA students. Previously Zider’s (1998) Harvard Business Review article had been one of the key information sources for MBAs.
Figure 3  Thesis' articles plotted next to VC cycle.

All these individual writing and research projects have, however, aimed at achieving the same purpose; providing more support for entrepreneurs in their interaction with investors. Hence, the general aim of the thesis is well founded (to improve the position of entrepreneurs in relation to venture capitalists and other risk financing sources (i.e. business angels and corporate venture capitalists) both before and after entrepreneurs have committed to a relationship).

Interestingly, when I started my thesis in 2003 one of the biggest problems for entrepreneurial finance was considered to be equity gap (promising entrepreneurs were not getting funding or were not getting any follow-on funding) (Mason & Harrison, 1992). However, now the emphasis has somewhat shifted into investment readiness (do entrepreneurial ventures have the capabilities to acquire funding, i.e. is the management experienced enough, business idea developed enough, etc.? (Mason & Harrison, 2001, 2004; Lahti, 2008). My thesis and particularly Article FOUR that recommends the utilisation of advisors in the VC process for entrepreneurs can be used to support entrepreneurs in making their business more “investment ready”. This, in turn, is what several venture capital and entrepreneurial finance scholars have called for (Mason & Harrison, 2001; 2004). In chapter 5 I present a more detailed discussion of the individual Articles. The articles are summarised in table 8 in chapter 5.6. From a practical point of view my research findings for entrepreneurs could be summed up as follows:

- Familiarise yourself with investors’ operating procedures and consider what kind of investor best matches your requirements (Articles ONE and TWO)
- Be selective while you choose an investor (Article TWO)
• Understand the power settings and their implications in the relationship (Article THREE)
• Utilise advisors during the negotiating and search process (Article FOUR)
• Understand that early-stage ventures may also benefit in terms of increased image after having VC investment (Article FIVE)

As mentioned above I have utilised various different theories and frameworks while I have studied and analysed the investor-entrepreneur relationship. From a theoretical point of view, and potential further research, my thesis has also provided various insights and suggestions regarding:

• The selection of investors by entrepreneurs is an interesting and relevant future research avenue (Article TWO).
• The resource based view is likely to provide one of the best starting points for analysing entrepreneurs’ requirements and what investors are able to provide (resources) (Article TWO).
• Power constructs are largely disregarded in entrepreneurial finance research, however they may provide important insights and frameworks into how the entrepreneur investor relationship should be organised (in terms of investment agreement, board composition etc.) (Article THREE).
• Entrepreneurial finance studies have disregarded advisors that influence the venture capital investing process. In other words, when advisors are involved the relationship it is not a dyad, as is commonly suggested. This is a new insight that should be taken into account when the investor-entrepreneur relationships are analysed (Article FOUR).
• In Article FIVE I prove, utilising media coverage as a proxy, that investor certification is applicable for very early stage ventures as well.

I have provided a brief introduction, motivation, aim and summary of the thesis above. Before I conclude the first chapter I will describe how I developed my various articles and provide information about my other (business) projects related to the research area. Then, I will introduce the main actors of the thesis (chapter 2), the context of the study, the Finnish entrepreneurial environment (chapter 3) and theories, frameworks and constructs that are relevant for the thesis (chapter 4). In chapter 5 I will provide a summary and report the main contribution of the Articles. After I have introduced the Articles14 I will utilise them in order to position the thesis (chapter 6). Chapter 7 concludes the thesis and includes a discussion on the limitations, validity and reliability, objectivity, and implications for practitioners as well as the theoretical implications of the thesis.

14 This thesis consists of five papers. Earlier versions of them have been presented at conferences or published in journals. Therefore, they are not all technically speaking articles. However, for the sake of simplicity I call all papers articles in this thesis. I refer to them simply as Article ONE, TWO, etc. A summary of the Articles is presented in phase 5.6.
1.3. Writing process and time line of the research process

I started my research project in 2003 and since then I have written several working papers, articles and conference presentations. This thesis is a synthesis of the various research projects and the five most significant fruits of the process were selected for the thesis. While working with these Articles and research projects I have also conducted several practical projects that relate to my research theme. For example, after I had written the first version of Article FOUR where I interviewed several advisors for start-up and early stage entrepreneurs that acquiring VC funding, I actually utilised one of those advisor firms. I became a founding partner in a start-up and we raised, with the help of advisors, over 2.5 MEUR in equity and debt financing. In addition, I have participated in several projects, from both a practical and from an academic researcher’s point of view, increasing my insight and helping me to gain a thorough understanding of the full meaning of various aspects of the research setting. For example regarding the findings of Article FOUR our practical experiences were well aligned with those that I came up with earlier in the research project. Another interesting aspect to acknowledge while reading my Articles is the fact that since I have been collecting data, editing, writing and rewriting them at the same time (see figure 4), and thus they might have many similarities that are not intentional. Articles are usually evaluated as independent entities (maybe a PhD thesis forms an exception) and, hence, I wanted to illustrate how their writing process and timeline is interlinked.

During my research period I have also spent 9 months in the U.S. and 3 months in Singapore. In figure 4 I have illustrated the development process and timeline of the Articles that were selected for the thesis. In addition, I have included in some other relevant milestones.

Figure 4 Development process of the Articles and some other relevant milestones.

The earlier version was published in 2006 at the Institute for the Small Business & Entrepreneurship Conference in Cardiff, U.K.
2 OVERVIEW OF THE KEY ACTORS OF THE STUDY

In this chapter I will first introduce the core concepts and actors in the venture capital business. In addition, I demonstrate the comprehensiveness of venture capital research and identify research gaps that this thesis concentrates on filling. I believe that the extensive literature about the research setting also supports my decision to approach the phenomenon from new angles and by writing somewhat “experimental” articles that should and will reveal new information.

Three actors, limited partners, venture capitalists and entrepreneurs have been commonly identified as key actors in the professional venture capital investment process. Limited partners are original investors that provide funding in the venture capital funds. Funds are legal entities that are managed by the venture capitalists (e.g. second group of actors). Venture capitalists are individuals that search and invest limited partners’ and some of their own money into entrepreneurial ventures (see figure 4 for more details). A third group of actors is entrepreneurs, e.g. the owners and managers of entrepreneurial firms. Also their role and characteristics are well documented in the venture capital context but not as well as VCs’ and more research from entrepreneurs’ point of view has been called for (Arthurs & Busenitz, 2003).

Figure 5 Limited partners, venture capitalists and entrepreneurs.

In addition to venture capitalists, there are two other groups of actors that invest equity capital in entrepreneurial firms: corporate venture capitalists and business angels. Their similarities and distinctions are explained in the chapters 2.3 and 2.4. Also Article ONE contains an extensive discussion about the similarities and differences between venture capitalists, business angels and corporate venture capitalists and the implications of their differences and similarities.

Although entrepreneurial finance terminology overlaps somewhat. It is suggested that venture capital funding, that is risk financing for entrepreneurial finance, is actually part of private equity funding. In addition to venture capital, private equity covers financing for larger deals such as leveraged buy-outs and management buy-out deals. These deals can easily exceed 10 million euros or even 100 million euros. This thesis concentrates on venture capital funding and particularly professional venture capital
funding and, to a lesser extent, business angel funding for growth companies. In addition, corporate venture capital is also discussed when it is relevant. The setting and concentration area of the thesis is illustrated in figure 6.

![Figure 6](image)

Figure 6  Three venture capital investing types: (professional) venture capital, business angel and corporate venture capital funding and the main concentration area of the thesis.

One of the most interesting and relevant outcomes of my thesis is the identification of an additional group of actors in the entrepreneurial finance process. In article FOUR, which was written with Lahti, I show that one group of actors has been largely overlooked in the prior literature; the advisors that influence the investor-entrepreneur relationship. Furthermore, we indicate that they also have indirect consequences for limited partners. Below (in figure 7) the key actors in the VC business and their advisors are presented and included in the process. The parties (i.e. venture capitalists, corporate venture capitalists, business angels and entrepreneurs) interact, communicate, negotiate, make contracts and cooperate with each other. Based on our research, it can be said that an advisor can support entrepreneurs in the process to a considerable extent, especially before the relationship has been formed.

![Figure 7](image)

Figure 7  Various investor types, entrepreneurs and advisors.
2.1. Limited partners

Limited partners “LPs” are e.g. insurance companies, pension funds and sometimes also wealthy individuals that desire to diversify their investments into high risk venture capital investments. They commonly provide approximately 99% of the money needed for venture capital funds (see figure 5 above where limited partners, venture capitalists and entrepreneurs are presented in one diagram). The funds are usually operative for ten years and after that proceeds are distributed to the limited partners. General partners (e.g. VCs) get approximately 15-25% of the carried interest of the investments (commonly called carry). In addition, VCs usually receive an annual 1.5–2.5% management fee calculated from the money that they have either raised from limited partners or funds that VCs have invested in their portfolio firms. LPs usually do not have the expertise, resources or connections for entrepreneurial firms and, therefore, VCs operate “in the middle” by screening potential entrepreneurial firms, negotiating a good deal with them and monitoring entrepreneurial firms after the investment (of the LPs’ money) has been made. The entire process aims at a successful exit (usually IPO or trade sale) after approximately 3-6 years (Lauriala, 2004).

The terms of venture capitalists’ and limited partners’ co-operation are determined in a partnership agreement. When LPs invest in a VC fund they cannot be sure of the outcome of their investment or how VCs will actually spend the LPs’ money. Therefore, extensive legal partnership agreements are drafted to ensure that both parties' interests are protected. E.g. Gompers and Lerner (1996; 1999) studied 140 partnership agreements between VCs and LPs. They found that there exists a broad heterogeneity among partnership agreements. In the agreement issues, such as compensation, distribution of earnings, reporting and accounting policies and preparation for various conflict of interest, many scenarios are determined (Sahlman, 1990).

Conner (2005) demonstrated how various fee structures between VCs and LPs actually affect LPs’ earnings in the long run. The relationship between limited partners and VCs has similar characteristics to that of the relationship between VCs and entrepreneurs. In the earlier case it was said that VCs that could be termed agents (those interacting with principals) and in the latter case it is entrepreneurs that are termed agents (Barry, 1994). Barnes and Menzies (2005) studied LPs’ investment behaviour in Europe. According to them, a VC’s reputation and historical performance are important decision criteria for LPs. LPs asked, for example, for opinions about entrepreneurs, other LPs and VCs. In addition, the authors showed that direct personal relationships between LPs and VCs are an essential prerequisite for VCs that raise money for a new VC fund from LPs.

Gompers and Lerner (2000) showed, in their extensively quoted article, how an inflow of LPs money into VC funds actually increased the valuation of the portfolio firms. The conclusion is that: when there is an excess of funds in the market, the VCs have to fight harder to find suitable investment candidates and, therefore, the valuations (e.g. VCs have to pay more to get the same amount of equity) of their portfolio firms increase. Robbie et al. (1997) studied LPs’ monitoring activities towards VCs. Based on interviews and a questionnaire, the authors determine that the monitoring of LPs is increasing and contains a broad variety actions and routines. Rosenberg (2003) has studied the litigation of LPs made against VCs and the reasons for and consequences of the litigation. According to the author it is not yet common but an increasing trend is that LPs will try to resolve or use the threat of litigation as a weapon to speed up negotiations with VCs.
In sum, LPs are the original and real source of money but they have outsourced the management of their money to venture capitalists. Earlier research has concentrated either on the LP-VC relationship or the VC-entrepreneur relationship. It has rarely discussed the relationship between LPs and VCs and how that influences VCs behaviour towards entrepreneurs on a working level. In article FOUR we have demonstrated that competent advisors may help entrepreneurs to develop high quality investment documentation material for VCs (business plan, executive summary, business case, etc.). When the material is developed correctly it can also be directly distributed to LPs by VCs. Depending on the decision process of the individual venture capital funds limited partners may participate in the decision process as well. Therefore, the better the material is the higher the chance of receiving VC funding is. LPs are common in the VC investment process and may influence the results, but they remain in the background. In order to be successful in acquiring VC funding it is also important to understand the role of LPs in the process.

2.2. Venture capitalists

Venture capitalist firms are companies that commonly manage several funds that have raised funding from LPs. The funds may concentrate on different industries, stages, geographical locations or their time span may vary. In figure 8 a venture capital firm that has several funds is illustrated.

![Figure 8](image)

**Figure 8  An example of a venture capital firm with several funds.**

VCs screen new entrepreneurial firms, analyse investment opportunities (also called due diligence), negotiate with entrepreneurial firms to ensure that their (and usually at the same time LPs’) interests are protected. After a VC has invested in a firm, it monitors the entrepreneur to observe whether it is behaving according to the VC’s interests and may provide value added for entrepreneurs. Examples of value added could be access to networks, consulting, motivation or acting as a sounding board (Sapienza et al., 1996). In addition, it has been suggested that by investing in an entrepreneurial firm a VC certifies the firm, meaning that it makes it easier to attract employees, customers, conduct other deals etc., especially after a reputable partner such as a VC has invested in the entrepreneurial firm (Seppä & Maula, 2001). However, data and empirical evidence that have been utilised to demonstrate that the certification effect, applied in the investor-entrepreneur context, occurs almost entirely with reference to stock market data on listed VC backed companies (Barry et al., 1990;
In Article FIVE I will utilise media attention as a proxy for providing certification in the very early stage venture capital backed firms.

VCs can also speed up the internationalisation process of their portfolio firms (Fernhaber & McDougall-Covin, 2009). Investors can potentially provide many positive consequences for an entrepreneurial firm but how can entrepreneurs ensure that this will materialise? In practice it is very difficult to bindingly ensure that this will actually happen. Article TWO concentrates on the selection of the best possible match for entrepreneurs in terms of value added and Article FIVE analyses the certification aspect in the relationship between VCs and entrepreneurs.

Venture capital funding differs from e.g. bank and other debt funding (e.g. leasing), as investors (VCs', CVCs' or BAs') do not usually get any other collateral than the venture's assets. When considering the typical research and development oriented ventures' that investors commonly fund, these firms do not have assets/collateral that could match the amount of capital that the investors invest in the ventures. In other words, investors take higher risks than banks when investing in entrepreneurial ventures. Investors compensate for the higher risk by having a higher expected return on capital (Sahlman, 1990). This means that when the firms are successful, investors might get their money back e.g. tenfold and sometimes they will lose everything (the venture goes bankrupt). In the VC literature, it is common to present the example that out of ten investments only one or two are great success stories, approximately 7 are adequate investments but do not fulfil the (highest) expectations and one to two are total failures (Sapienza et al., 1994).

Investors' and particularly the VCs investment process has been said to contain the following phases: search/deal origination, screening/initial screening, evaluation, due diligence, deal structuring, post-investment activities, the monitoring process, cashing out/exiting (e.g. Hall & Hofer, 1993; Tyebjee & Bruno, 1984). The articles that this thesis is based on concentrate on the various phases of the process. In chapter 6.1 (see figure 11), I present my Articles plotted in a venture capital investment process cycle chart. Ehrlich et al. (1994) have studied, among other things, VCs' operating procedures during the post-investment phase. Based on their survey, conducted in the U.S., VCs communicate with LPs, help obtain additional VC funding, monitor the performance of entrepreneurial firms, serve as a sounding board and help formulate business strategy. According to Gorman and Sahlman (1989) VCs spend approximately half of their time on monitoring activities. On average one venture capitalist (i.e. a person) has nine portfolio firms to monitor and on average he or she sits on the board of directors on five of them. For those firms where the VC sits on board, he or she devotes approximately 80 hours onsite support and 30 hours telephone support annually per firm. According to Fried and Hisrich’s (1995) case study of 14 VC-entrepreneur dyads, VCs spend 5-14 hours working for each entrepreneurial firm per month. However, these figures are averages and they could vary considerably depending on the situation of an individual entrepreneurial firm (Fredriksen et al., 1997). From an individual firm’s point of view it is, therefore, essential to ensure that the firm gets as much support as is possible. In turn, from the VCs’ point of view, optimal resource allocation could be something totally different (Sahlman, 1990). A key point to understand is that the earlier phases of the relationship will have a major impact on the later phases. For example, how the contracting is conducted between the entrepreneurs and investors has major implications for the post-investment phase. What makes it difficult to study is the fact

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that investment agreements are commonly confidential and researchers only rarely have access to the data (Norton & Tenenbaum, 1993; Marx, 1998; Kaplan & Strömberg, 2000; Isaksson et al., 2004). However, many practical books about venture capital explain various contract covenants and their implications in detail (see e.g. Cardis et al., 2001, Lauriala, 2004; Benjamin & Margulis, 2005; Bloomfield, 2005). In addition, some industry reports provide quarterly information on the average investment sums and ownership percentages that VCs get from their portfolio firms\textsuperscript{17}. Finally, investment contracts between investors and entrepreneurs usually contain various clauses that ensure that entrepreneurs have a high interest in behaving according to the investors’ interest (Kaplan & Strömberg, 2003). Contracting may potentially contain several very dangerous and risky elements for entrepreneurs. The less experience the entrepreneurs have of contracting, the higher the chances are that entrepreneurs will commit themselves to these unwanted contract covenants. In Articles TWO and FOUR I analyse how entrepreneurs could ensure that they get as much value added from VCs during the relationship (i.e. the post-investment phase) as possible, how behaviour during the pre-investment phase relates to that and how entrepreneurs could mitigate the risks of investment contracts.

Partially relating to the VC investment process approach, various scholars have studied VCs’ investment criteria and the problem of how to select a successful venture. Issues such as a venture’s stage (e.g. is an investment candidate a start-up or a more developed firm), geographical location, industry sector and the entrepreneur’s experience and even “gut feeling” influences whether a VC firm is willing to start a detailed evaluation of a venture and eventually invest in a firm (Khan, 1987; Gupta & Sapienza, 1992; Elango et al., 1995). Baum and Silverman (2003) raised the interesting point of whether VCs actually select good investment candidates (e.g. scout them) or if it is so that VCs actually build them (e.g. coach them). Based on the scholars’ Canadian data, they came to the conclusion that the VCs’ role is mixed. VCs’ decision making has been analysed in various studies (MacMillan et al., 1985; Khan, 1987; Hisrich, & Jankowicz, 1990; Cable & Shane, 1997; Zacharakis & Meyer, 1998; Kemmerer et al., 2002; Shepherd et al., 2003; Guler, 2003). In Article TWO, I have turned the question of the VCs’ and entrepreneurs’ on its head and analysed entrepreneurs’ decision-making criteria when they are selecting investors. This approach has – considering the potential value added of a good match, – attracted surprisingly little attention in previous research (Ehrlich et al., 1994).

The risks of VC funding have also been analysed and conceptualised, and VCs’ elimination and risk reduction strategies have been developed (MacMillan, et al., 1985; Ruhnka & Young, 1991; Norton & Tenenbaum, 1993). In general, the younger the venture is the more risk it can be said to contain. This has also links to the expected return that VCs require from their investment: the higher the risk the higher the IRR (internal rate of return) (Norton & Tenenbaum, 1993). One way to conceptualise the risk of VC investments is to consider risks related to the venture and its business: In early stage ventures most of the risk relates to the business concept. When the venture develops technological and other issues regarding the business concept are the main concerns of investors. When the R&D-phase approaches its goals, investors see that risks related to getting the product or service to the market and organising the production as the most relevant risks. In the fourth stage, investors see that most of the risk comes from competitors or that the markets are not willing to buy the developed product. The fifth and final stage contains risks that will prohibit investors from selling their venture at a maximum profit (Ruhnka & Young, 1991). Another risk factor for

\textsuperscript{17} See e.g. PWC Moneytree or VentureONE database (De Clercq et al., 2006).
investors is formed by the entrepreneurs themselves. In short, the entrepreneur may say something and do something totally different. For example, entrepreneurs may want to put more effort into research and development activities for personal reasons, rather than what would be optimal for the venture. Entrepreneurs may also spend investors’ money lavishly or start a competing venture (Amit et al., 1990A, Barney et al., 1994). Investors could, for example, provide funding in stages to decrease the risks associated the venture (e.g. not all the money is lost if the venture fails for one reason or the other) (Gompers, 1995). In addition, VCs commonly and actively monitor entrepreneurs in order to ensure that their interests are protected and also to mitigate risks (Lerner, 1995; Robbie et al., 1997). In Article FOUR the idea that an experienced advisor may be able to position and present the entrepreneurial venture to investors in such a manner that the role of risks are not seen as high by investors is presented.

Other research has concentrated on the VC-entrepreneur relationship and post-investment relations. Various theoretical approaches have been utilised to explain the parties’ relationship (see e.g. Cable & Shane, 1993; Steier & Greenwood, 1995; Sapienza & Korsgaard, 1996). Theories and theoretical frameworks are discussed in detail in chapter 4. The value added that a VCs’ relationship and involvement with entrepreneurs could provide is also a broad research area. The results are somewhat inconsistent and some studies have shown that VCs’ provide clear value added for entrepreneurs (see e.g. Sapienza, 1992) while others do not (Gomez-Mejia et al., 1990; Steier & Greenwood, 1995; Manigart et al., 2002). It has been suggested that survival bias (Manigart et al., 2002) may explain the controversial results. Non-surviving companies disappear and are not included in analysis, thereby indirectly improving results. Kaplan and Strömberg (2003) have studied the allocation of rights between VCs and entrepreneurs. They classified rights as cash flow, board, voting, liquidation and other control rights. According to their study of 213 investments one could summarise that when a venture performs poorly VCs usually get full control of the company. However, due to the nature of VC investing, in which many investments fail and a few investments pay back the loss on failed investments, the VCs aim to maintain tight control of the venture. Rights are allocated in investment negotiations therefore, it is very important that entrepreneurs really acknowledge what they are committing to. This leads back to the research areas of Articles TWO and FOUR. In addition, in Article THREE the investor-entrepreneur relationship is analysed from a fresh viewpoint: the power between the parties and the dynamic nature of the power in the relationship is analysed.

The potential value added that VCs could provide can be acting as a sounding board, business advisor, financier, mentor/coach, friend/confident and provider of contacts, relevant professional advice and help in recruiting suitable resources (Sapienza et al., 1996). In addition, it has been acknowledged that at least two different VC investing strategies exist: specialisation and diversification. In specialisation, a VC firm invests in, for example, a certain industry, stage or technology. The diversification strategy in VC investing refers to a portfolio that is diversified across industries, stages or geographical areas (Norton & Tenenbaum, 1993; Manigart, et al., 2002). It has been suggested that if a VC selects a diversification strategy it might be very difficult to provide adequate value added for its portfolio firms (Sapienza, 1992). Article TWO acknowledges the importance of investors' potential value added and concentrates on the question of how entrepreneurs can ensure beforehand that they will get value added from their investor after the investment has been made. Article FOUR, in turn, approaches the phenomenon of selection from a different angle. Entrepreneurs are not able to analyse i) what resources are needed, ii) what resources investors are able to provide them with, thus, advisors are needed.
Probably, the most important forum, where interaction between investors and entrepreneurs materialises, is the board of directors (BoD) of a venture. Therefore, the role of the BoD has also attracted research attention. Rosenstein et al. (1993), for example, studied the implications for BoDs after VC involvement. They found that entrepreneurs ranked the value added provided by high quality VC firms higher than that of other VC firms. Fredriksen and Klofsten (1999) showed that when power was evenly distributed between the BoD and the management team, it had positive consequences for the success of the venture. Article THREE especially concentrates on the power relationship aspects between investors and entrepreneurs (I utilised business angel data for this). Power constructs as such are rarely utilised in the VC post-investment context (see exception in Fried & Hisrich, 1995; Fiet et al., 1997; Fischer & Pollock, 2004)\(^{18}\).

In sum, the area of venture capital has been extensively researched during the last twenty years and the main attention has been diverted towards venture capitalists (Wright & Robbie, 1998; Denis, 2004). However, there are various untouched research areas and gaps that are both academically and from a practitioners’ point of view relevant. Articles TWO (the selection process of VCs by entrepreneurs), THREE (power in the relationship), FOUR (the role of advisors in capital acquisition process) and FIVE (the certification effect of VC backed entrepreneurs) have successfully concentrated on these gaps and provide new insights and viewpoints.

2.3. **Corporate venture capital**

Corporate Venture Capitalists and Corporate venture capital (CVC) is one specific form of venture capital funding where a large company invests in entrepreneurial firms in order to fulfil some synergic, technological or other strategic targets. Monetary gains are sometimes secondary in CVC. Dushnitsky and Lenox (2003), for example, studied conditions under which firms are likely to pursue equity investment in new ventures. According to the authors CVC can be seen as a way to source innovative ideas. This is an important difference between traditional VC investments. For example, A CVC unit that is founded by a forest company may be willing to consider investing in ventures that have some strategic fit with the mother company (i.e. forest industry). Maula et al. (2005B) suggested that CVCs value added functionality is very different in comparison to VCs. While VCs concentrate on finance, recruitment, the professionalisation of the venture, CVCs provide more support in terms of increased credibility, capacity and technological support for their portfolio firms.

Investments in entrepreneurial firms can be made indirectly via an independent VC fund or the company can invest directly by forming a corporate VC fund of its own (McNally, 1995). According to Shrader & Simon (1997), corporate VCs emphasise internal capital resources, proprietary knowledge and market expertise. Research on CVC funding has also shown that CVC units often lack a clear mission, the commitment of the funding company is not always sufficient and the compensation schemes for the managing partners are not as rewarding and motivating as in independent VCs (Denis, 2004). According to Manigart et al. (2002) corporate VCs might e.g. be satisfied with lower return levels and an investment could be for them only a method of obtaining new information, technology, property rights or business opportunities.

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\(^{18}\) Economics studies have utilized power-construct somewhat more often in this context see e.g. Bowden (1994) or Fairchild (2004).
For entrepreneurs CVC investors may provide advantages and disadvantages. In an optimal case a well-known corporate investor (e.g. Sony, Nokia, Intel and GE have their own corporate venture capital arms) may provide important industry contacts, technological insight and credibility. On the other hand the mother company of the CVC has its own strategy and that may have implications for the strategy of the CVC as well. For example, case company B in Article TWO originally had a CVC investor that decided to cut down its finance because they started to co-operate and finance another competing software firm (this has not been extensively discussed in Article TWO since it was not relevant for the research setting of that particular Article). A professional VC would most likely not have done that, but since the CVC's mother firm and portfolio firm had different strategic interests the value added benefits did not materialise. It may also be costly for portfolio firms to deliver confidential information to CVCs since they can exploit that information (Dushnitsky, 2004). Gompers and Lerner (1998) showed that it is important to ensure that the CVC program has a consistent investment strategy since CVCs that lack such a strategy are less successful with their investments.

In sum, from the point of view of this thesis the role of a CVC is not that significant. It is, however, important to acknowledge this source of funding for entrepreneurs with its similarities and differences between professional VCs and business angels. Article ONE concentrates on the differences and similarities of various funding sources. It is also good to acknowledge that sometimes (and I repeat only sometimes) from an entrepreneurs' point of view it may be irrelevant where they get funding from, as long as they get funding and can continue to develop their business. This situation could occur when entrepreneurs are really only after funding not value adding resources or the improvement of the entrepreneurial firms' image. Finally, regarding CVCs, it could be that they co-invest along with other investors in an entrepreneurial venture in order to get an opportunity to interact with such investors as well (see Article ONE).

2.4. Business Angels

The third and final group of potential equity investors for entrepreneurs are business angels. They are private individuals that invest a portion of their own assets in entrepreneurial ventures. According to Freear et al. (1994), they mainly prefer to invest in the earlier stages of a venture and tend to set lower performance targets than VCs. Their motivation for investing may be somewhat different than VCs. Business angels may be motivated by something other than financial gain, e.g. benefiting society and seeking enjoyment (Lahti, 2008). Another important distinction relates to business angels’ source of funds. Since they invest their own wealth, business angels might take different situations and possible problems more personally that other investor types (Berggren & Fili, 2008).

Ehrlich et al. (1994) have compared business angels and VCs. According to their findings VCs and business angels have a lot in common and they differ only modestly from each other. The most important difference between VCs and business angels was the lack of support from business angels to entrepreneurs in certain situations. According to Wong’s survey (2002), for example, only 24% of the angels were willing to provide help in the identification and recruiting of a management team for their investees. This is a rather low figure considering that angels commonly invest in early stage firms that are more likely to have less experienced executives. Furthermore, VCs tended to also set higher performance standards than business angels and business
angels were relatively more active in the early investment stages than later ones. According to Van Osnabrugge (2000) business angels tend to place more emphasis on involvement with their portfolio firms after the investment than e.g. VCs. The author concluded that high involvement is a complementary method to tight legal contracting in order to monitor portfolio firms, for which legal contracting is preferred by the VCs. Due to the differences between angels and VCs it has been suggested that ventures with a technical or market advantage may benefit more from VCs, and that ventures with very capable and trustworthy managements might benefit more from angels (Fiet, 1995).

Several research projects have also tried to classify business angels according to their investment policies and behaviour. At least the following terms have been suggested economic investor (the main emphasis is on financial return on investment), hedonistic investor (main emphasis is on personal pleasure and the diminishment of trouble), altruistic investor (main emphasis is on charity), lotto investor (low level know-how and value adding capabilities, these investors are fairly inactive), trader (active investors but only low value adding capabilities) and analytical investor (fairly competent but inactive investors) (Sullivan & Miller, 1996; Sørheim & Landström, 2001).

In this thesis, I have covered business angels first in the literature review of Article ONE where we have compared, from an entrepreneurial point of view, different investor types. In Article THREE I have acted as a business angel myself and invested in an entrepreneurial venture. In this explorative study I mainly concentrated on the power aspects between entrepreneurs and a business angel. Even though the Article uses only participant observation data from a single entrepreneur-business angel situation/relationship it can be argued that at least, to some extent, the propositions can be expanded to VC and CVC settings, especially when VCs and CVCs invest in early stages. In the other Articles the role of business angels is more limited.

2.5. Entrepreneurs and entrepreneurial ventures

Schumpeter was one of the first scholars that conceptualised and defined entrepreneurs and his definition is still the most renowned. According to Schumpeter, entrepreneurs form a “creative destruction”. In other words established ways of doing things are destroyed by the creation of new and better ways to get things done. Davidsson (2004) wrote: “there is no shortage of suggestions as to what the phenomenon “entrepreneurship” really consists of”. In the table 1 some suggestions are listed.

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20 See Grebel et al., (2003) for discussion how Schumpeter came to his definition of entrepreneur and other distinguished entrepreneurial theorists.
What is entrepreneurship? Some suggestions

- New Entry (Lumpkin & Dess, 1996)
- The creation of new enterprise (Low & Macmillan, 1988)
- The creation of new organisations (Gartner, 1988)
- A purposeful activity to initiate, maintain and aggrandise a profit oriented business (Cole, 1949)
- Taking advantage of opportunity by novel combinations of resources in ways which have impact on the market (Wiklund, 1998)
- The process by which individuals - either on their own or inside organisations - pursue opportunities without regard to the resources they currently control (Stevenson & Jarillo, 1990)
- The process of creating something different with value by devoting the necessary time and effort; assuming the accompanying financial, psychological, and social risks; and receiving the resulting rewards of monetary and personal satisfaction (Hisrich & Peters, 1989)

Table 1  What is entrepreneurship (From Davidsson, 2004)?

However, from the perspective of this thesis, the relevant characteristic is high growth entrepreneurial ventures that have the possibility to acquire venture capital funding. This is an important notion since it also tells that this thesis concentrates on a very limited group of ventures (and entrepreneurs) that are so high quality that they may attract the attention of equity investors (e.g. venture capitalists, business angels or corporate venture capitalists). Only a very small percentage of firms i) consider themselves applicable for VC funding and ii) are able to maintain such a high growth that it ensures a profitable exit for investors. Eventually from this small group of firms a very small percentage will actually be able to acquire VC funding\(^{21}\). These high growth firms are also called “Gazelles” (St-Jean & Julien, 2008). According to Dubini (1989) and Barney et al. (1996) the VC backed entrepreneurs are not homogenous, even though they are a fairly diverse group of firms. The diversity of the ventures influences the value added that an investor can provide.

Even though it has been suggested that the entrepreneurial’ viewpoint requires more research attention (instead of the VCs’) (Arthurs & Busenitz, 2003), entrepreneurs have attracted attention. Bruno and Tyebjee (1985); Ehrlich et al. (1994) and Barney et al. (1996), among others, have studied the venture capital business from the point of view of entrepreneurs. They have concentrated on the following aspects: the level of VC involvement in the entrepreneur’s business (entrepreneurs prefer more involvement regarding additional equity and debt financing), how much and what kind of value added has the VC been able to provide the entrepreneur’s business and how long does it take to get funding (median 4-5 months while 20% of the firms do it in two months and another 20% spends more than 8 months organising funding). Also VC backed entrepreneurs’ skills and previous experience have been studied, and according to

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\(^{21}\) In Finland 2008 there were 321,000 companies registered (According to Statistics Finland (http://www.tilastokeskus.fi/ti/syr/2008/syr_2008_2009-11-27_tie_001_fi.html) and 265 firms raised VC funding in that year (According to FVCA). Business angel investors and VC and CVC firms that are not members of a FVCA are excluded.
Bruton et al. (1997) VCs prefer strategic skills over operational skills. An entrepreneur’s experience also influences the VC-entrepreneur communication intervals (Sapienza & Gupta, 1994).

Several research projects have come to the same conclusion and emphasise the importance of a suitable VC for specific needs (e.g. Barney et al., 1996 and Sapienza et al., 1996). Article TWO of the thesis concentrates on this research theme. The Article promotes the idea that entrepreneurs should conduct their own analysis (due diligence) of a potential investor and analyse pros and cons. This is especially relevant when entrepreneurs have multiple investors that they can choose from. Manigart et al. (2002) stated that entrepreneurs should understand more thoroughly the factors influencing VCs’ decisions as this could improve the entrepreneur’s position during their negotiations with VCs. Manigart et al.’s proposition is supported by Articles TWO (in short, by better understanding investors’ operating procedures, the potential value added that entrepreneurs could get and the entrepreneur’s most critical shortcomings, thereby, entrepreneurs may be able to obtain the best possible investor) and FOUR (advisors who are more experienced in negotiating with investors may be able to organise better deals for entrepreneurs than entrepreneurs would on their own). Hellman and Puri (2002) surveyed Californian start-up firms and according to their study it is significantly more likely that VCs’ portfolio firms professionalise themselves according to various dimensions, such as HR policies, the recruitment of marketing and sales operations and option plans. Furthermore, it is also significantly more likely that the founders are replaced by external CEOs after VC involvement. Therefore, and almost paradoxically, VCs’ provide positive consequences for the venture but at same time the consequences for individual entrepreneurs may be negative (e.g. being made redundant). And as suggested above, it is very important for entrepreneurs to analyse and make informed decision about investors (Article TWO) and utilise professionals while negotiating with investors (Article FOUR).

In sum, this thesis concentrates on entrepreneurs who have the possibility to receive VC funding. In addition, it considers entrepreneurial theories and statistics about newly founded and young companies. However, by concentrating on ventures that have a realistic chance of being funded by VCs, I simultaneously exclude other types firms.

2.6. Advisors

Advisors form the last group of actors that is relevant to my thesis. They provide support for entrepreneurs who need to contact investors, negotiate with them and eventually help entrepreneurs draft a deal with them. Article FOUR concentrates on the role of advisors in the VC process. The paper received its start from interviews related to Article TWO. In one interview an entrepreneur described how beneficial it was to have an advisor to help in the VC funding process. Inspired by that piece of information I started to examine the advisor’s role in depth and prior research focusing on advisors in venture capital setting. First, I was not able to find any relevant academic studies that had concentrated on their role. In addition, the entire VC literature implied that the relationship between VCs and entrepreneurs was a dyad. Based on the information that I got from my interviewee I started to understand that advisors can potentially

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22 Eventually I was able to locate Hustedde & Pulver (1992) and Murray & Wright (1996) that had somewhat concentrated on the same research area. However, our article is the first one that solely concentrates on the question of how advisors operate and what kind of value added they could provide for entrepreneurs that acquire VC funding. However, in business literature the role of advisors is somewhat touched upon. See Appendix 1 for more information.
have a considerable impact on the dyad particularly during the pre-investment phase. Advisors can be determined as independent specialists that help entrepreneurs acquire VC funding in exchange for a fee.

In short, based on Article FOUR and the case data, the advisors only choose entrepreneurs that they believe have sufficient potential to attract VC funding. Most advisors have their own reputation to protect and consequently they want to retain a good track record by selecting only cases that they believe have a good chance of getting VC funding and earning them fees. An advisor’s revenue comes from two components: a retainer fee that entrepreneurs pay regardless of whether the project is successful or not, and a success fee, typically 2–3% of the funds that are acquired. When the assignment is successful and the advisor is able to acquire VC funding the success fee is much more significant than the retainer. According to our data, many of the entrepreneurs have neither the time nor the required expertise to come up with material that convinces the VCs of the potential of their business as an investment opportunity. Therefore, advisors may have a crucial role in educating the entrepreneur about the VCs’ investment procedures and eventually attracting VC funding. Advisors may also provide insights into which VC an entrepreneur might approach based on the entrepreneur’s individual needs. An advisor’s involvement could also improve the terms of the deal from an entrepreneur’s point of view and possibly also the valuation. From a VC’s perspective, advisor involvement may increase or decrease the credibility of the investment opportunity. The fact that investment opportunities involving advisors have already been screened and analysed by an advisor tends to increase their credibility in the eyes of the investors. The involvement of advisors is described in figure 9.
The main disadvantages of utilising advisors that were identified in Article FOUR were that it may take a considerable amount of time to locate a suitable advisory firm, advisor firms charge a retainer that has to be paid by the entrepreneurs even if the venture would not able to attract VC funding, advisors may have too strong a say on the venture’s operations and in some cases overshadow the entrepreneur in the meetings and negotiations, suggesting that entrepreneurs are not capable enough of negotiating and interacting with people – a skill that is needed in their day-to-day business. However, we came to the conclusion that contacting VCs without advisors is only appropriate for entrepreneurs that have extensive prior experience of VC funding. The conclusions are based on the qualitative interview data of five advisor firms, three entrepreneurs and four venture capital firms. It is, however, important to acknowledge that there are various other sources of advice that could help entrepreneurs in the process of acquiring capital. As far as I am aware of, Article (FOUR) is the first to concentrate on the role of advisors in the process. From the point of view of this thesis the role of advisors is extremely relevant and provides important additional
information to the research area that can be summed up as follows. First, the
identification of this group of actors is itself interesting. Second, the practical
implications that it provides for entrepreneurs may be very significant. Third, while
evaluating the investor entrepreneur-relationship through theoretical lenses it might be
beneficial to extend that evaluation to a third group of actors i.e. advisors. The role of
advisors and the acknowledgement of their existence may potentially provide new
insights and viewpoints into analysis.
3 CONTEXT OF THE STUDY: FINNISH ENTREPRENEURIAL FINANCE ENVIRONMENT

Regardless of the fact that I spent approximately one year in the U.S. and one Fall in Singapore while writing the thesis all the data that this thesis is based on is collected from Finland. Therefore, it is designed to provide basic facts about the Finnish entrepreneurial finance environment. Below, I will first shed light on the professional venture capital industry, then on business angels and finally on corporate venture capital in Finland.

The Finnish venture capital industry is fairly small but still fairly well established and maintains strong international connections. According to Teubal and Luukkanen (2006), Finnish (early-stage) VC funding is fairly well developed in comparison to many other European countries. Rekola, Laaksonen and Piha (2008/2009) have come to the same conclusion, according to them Finnish venture capital and private equity industry is well established and attracts considerable investment from abroad. In addition, the Finnish market is well-networked internationally and most Finnish venture capital funds are members of the Finnish Venture Capital Association that cooperates with other European venture capital associations by belonging to the European Venture Capital Association. The association’s goal is to promote unified and standardised operating procedures across countries in Europe. Therefore, I believe that the findings and suggestions of the thesis that are based on Finnish data could be applicable in other markets as well. Next, I will briefly discuss the Finnish venture capital industry, business angels and corporate venture capital.

3.1 Venture capital industry in Finland

Even though the Finnish venture capital market is fairly small there are a few academic studies that have concentrated on the Finnish market or have been included in Finnish data. For example Parhankangas and Landström (2004; 2006) have studied how Finnish and Swedish VCs react to disappointments caused by entrepreneurs. According to the authors the more experienced the VCs are the more willing they are to be constructive with their approaches to entrepreneurs. De Clercq et al.’s article (2001) collected an extensive data set from among Finnish VC firms between 1994 and 1997. The key findings of their study were that VC firms are fairly specialised (compared to their diversification strategy). In addition, the longitudinal effects of the VCs’ portfolio were analysed. The main effects were increased geographical diversification and a transferring of activity towards later stage deals during the research period.

A few dissertations have concentrated on the Finnish VC environment as well. Koski (2000) utilised fuzzy logic to explain VCs’ perceptions and decision making. Seppä (2000) has identified six different venture capitalist types. Lehtonen (2000) studied different exit vehicles that VCs have utilised. Maula et al. (2006) completed a three part research project concentrating on early stage VC funding. In that project, the researchers compared Finnish markets with bigger counterparts and conducted field trips to Israel, the U.K. and the U.S. According to the project, the annual figure of early stage firms that acquire VC funding is substantially higher than was expected in Finland. The figure is roughly 800-1000 firms. Luukkanen (2008) analysed private
VCs, captive VCs\(^{23}\) and business angels' value adding role in Finland. Based on her findings, a captive VC was found to be the least active and provided the least additional value added for their portfolio firm when compared to private VCs and business angels.

According to statistics provided by FVCA and PEREP\(^{24}\) the Finnish venture capital market is highly concentrated on later-stage, buyout investments when volume is measured in invested capital (later stage investments are not the emphasis of this thesis, however). According to statistics later stage deals attracted 726, 681 and 580 million euros worth investments in 2008, 2009 and 2010, respectively, while early stage venture capital investments attracted 127, 93 and 97 million euros. When the business is evaluated in terms of how many portfolio firms attracted funding the situation is different. Later stage investments were invested in 82, 70 and 72 companies, while venture capital investments were made in 196, 167 and 150 portfolio firms in 2008, 2009 and 2010, respectively. When comparing the Finnish venture capital market to the European venture capital market, the Finnish venture capital market is somewhat above the European average in comparison to private equity investments as a percentage of GDP. In Finland the figure is 0.227% while the European average is 0.186% of GDP. For the purpose of comparison, the U.K. has the most active VC market in Europe with a figure of 0.566% in private equity investments in comparison to GDP, Germany’s percentage is 0.101% and Sweden’s is 0.432%\(^{25}\).

3.2. Business angels in Finland

One of the first academic studies among Finnish business angels was conducted by Lumme et al. (1998). The researchers concentrated on characterising Finnish business angels and providing policy recommendations. An updated review of the Finnish business angel market was provided by Lahti (2009) in his dissertation. As Lahti pointed out in his dissertation, Finnish markets have changed considerably since Lumme et al.’s study (the data were collected in 1994). Lahti made the most extensive study on Finnish business angels in terms of sample size. According to his findings Finnish business angels’ investment practices are fairly similar to those of VCs, they emphasise extensive due diligence and are very careful when selecting portfolio firms. In addition, BAs are quite hands-off in their involvement with ventures and prefer working through a venture’s board when influencing a venture.

While we could refer to FVCA’s statistics when evaluating the size of the professional venture capital market, there are much less data available on the size of the business angel market. Mason and Harrison (2000) collected a list of various methods that have been utilised in order to analyse the size of the business angel market. Methods such as the evaluation of how many companies have received funding (the demand side) and, on the other hand, how many people have the economic means to provide funding (supply side) for early stage firms have been utilised (Wetzel, 1986A; 1986B). Another method used was to examine a small sample of firms and then expanded the results to cover the entire (U.S.) population (see e.g. Gaston, 1989). Similarly, the third approach relies on results from one geographical area that are then expanded to cover the entire

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\(^{23}\) “Captive VC” refers to a venture capital firm that is established by financial institutions (e.g. pension funds, insurance companies or banks) and invests capital from their parent firms (Van Osnabrugge & Robinson, 2001).

\(^{24}\) This information comes from a joint presentation by the FVCA (Finnish Venture Capital Association) and PEREP (centralized non-commercial pan-European private equity database) published in 2011.

\(^{25}\) This data was retrieved from the www.evca.eu and www.fvca.fi websites on 17th of March 2011.
It has been estimated that the size of the business angel market is considerably larger than the VC market (see e.g. GEM report 2002\(^{26}\)). In Finland, various estimates have been provided (Lahti, 2007; Maula et al. 2005A). First, only members of the Finnish business angel network are included in an estimate providing a figure of 350 business angels\(^{27}\). By applying the logic of Mason and Harrison that only 20% of the business angels belong to business angel networks, a figure of 1750 angels was derived. Finally, the third method of analysing the size of the business angel market leads to a figure of 150,000 business angels in Finland! This “rather” high figure compared to the previous two is derived from the following logic: approximately 2000 phone interviews were conducted among the adult population per year between 2000 and 2002 in Finland in the GEM research project and found that 3% of the research subjects had made some kind of informal investment\(^{28}\). To expand this figure to the entire Finnish population leads to approximately 150,000 investors. Obviously, the 350 business angels that belong to a business angel network form a much more homogenous group than the 150,000 investors that are derived using a “3% strategy”. In other words, the more heterogeneous the group is, the more difficult it is to study and present insights that are generally applicable. Therefore, it is likely that my thesis is more applicable for situations that involve business angels that are estimated by using the “members of the BA network” logic rather than the “3% of the adult population that has made some sort of informal investment”.

<table>
<thead>
<tr>
<th>Number of business angels</th>
<th>Estimation logic</th>
</tr>
</thead>
<tbody>
<tr>
<td>350 business angels</td>
<td>“Members of BA networks”</td>
</tr>
<tr>
<td>1,750 business angels</td>
<td>“Only 20% of all business angels belong to a network”</td>
</tr>
<tr>
<td>150,000 business angels</td>
<td>“3% of the adult population has made an informal investment”</td>
</tr>
</tbody>
</table>

Table 2 Various methods to evaluate the amount of Finnish business angels.

### 3.3. Corporate venture capital in Finland

Finnish corporate venture capital is a very limited business. There are only a few Finnish firms that have a corporate venture capital arm. Before the economic downturn and dot.com crisis in 2001, several large Finnish corporations had their own venture capital arms (Luukkonen, 2006). However, corporate venture programs are much more often exposed to the (short-term) decision making and cost-cutting initiatives of corporations. It has been suggested that CVC programs are often created when markets are already overheated, shrinking and when valuations of their investments are at their

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\(^{27}\) Finnish Business angel network was earlier operated by Sitra. A new network was founded in 2006 and is operated by Vera Venture. The earlier members were not automatically transferred to the new network. Both organizations are government backed.

\(^{28}\) Note the challenges and confusions that the terms informal investment and business angel investment can create. However, informal investors are generally assumed to be less professional than business angels (Avdeitchikova et al., 2008). The 150,000 business angels estimate also contains these informal investors.
lowest (Maula, 2001). Probably the best known and biggest Finnish firm Nokia does have its own corporate venture capital unit, Nokia Growth Partners. Currently Nokia Growth Partners has one Finnish portfolio firm\(^29\). In the U.S., for example it has been estimated that CVC represents approximately 6-8 percentage of all VC investing (MacMillan et al., 2008). In Finland there are no estimates available (Hernesniemi & Viitamo, 2006). My own assessment is that in Finland there are considerably less CVC investments.

4 OVERVIEW OF THE KEY THEORIES, FRAMEWORKS AND CONSTRUCTS OF THE STUDY

In this chapter I will present the main theoretical frameworks and concepts that I have utilised and this thesis is built on. Due to my approach of selecting very different methods and viewpoints to analyse and research the entrepreneur-investor relationship, I have utilised several different theoretical frameworks and theories. I believe, however, that all viewpoints provide us with additional insights and constructs that could help us understand the complex relationship between investors and entrepreneurs.

I believe that academic studies should ultimately lead to improvements in the practitioners who act as the subjects of the research, or at least there should be a connection between academic research and the “real world”. Nevertheless, the testing of a hypothesis derived from only one framework may lead to over-simplified results in venture capital and entrepreneurship research. In addition, although the hypothesis being tested might receive strong support from the empirical data, it might not provide an extensive picture of the phenomena under research. In my thesis I have approached various interesting and relevant “sub-themes” by utilising the most applicable theoretical construct or constructs that have been available. Next, I briefly introduce the most relevant theories, constructs and frameworks from my thesis’s point of view. I present what elements they emphasise and disregard. A vast number of theories and frameworks have been utilised in this context over the last few decades. Most of the relevant theories and frameworks from my thesis’s point of view are based on agency theory (utilised in Articles TWO, THREE and FOUR), the resource based view (Article FOUR, and ARTICLE TWO), the certification effect (also called signalling) (Article FIVE), the procedural justice theory (Article THREE). In addition, in Article THREE, I extensively discuss various power constructs. Due to the nature of Article ONE, it approaches the phenomenon of entrepreneurial finance from a more practical viewpoint, therefore the theoretical discussion is weaker in that Article.

It is good to recognise that a vast number of other theoretical constructs and frameworks have been utilised in this context before as well: e.g. prisoner’s dilemma, stewardship theory, institutional theory, (e.g. Zacharakis et al., 2007), organisational ecology theory (Manigart, 1994). Finally, a single paper illustrates how extensive the utilisation of the various frameworks has been: Ferrary (2003) utilised the gift exchange construct to explain co-investing among venture capital funds and other social relationships between entrepreneurs’ and venture capitalists. I believe that due to the extensive earlier research and the data available it is well founded to have the approach used here; identify smaller but relevant research gaps, try new research approaches and build research by closely referring to previously utilised theories. This

30 It is an interesting debate on what is actually the difference between a theory and a framework. For example, Priem and Butler (2001) have suggested that resource-based view is not a theory.

31 It is important to acknowledge the fact that signalling has been suggested as one solution for an agency problem called adverse selection (Spence, 1973). Therefore, why have I mentioned signalling separately when I already have agency theory as one key theoretical framework of the thesis? The answer is that in article FIVE I have only concentrated on the signalling component and for some readers it might not be as evident that the reference to agency theory also includes the notion of signalling.

32 In short Ferrary (2003) suggests that venture capitalists do favours for each other, such as share information and invite each other to co-invest. This behaviour has similarities to the gift exchange tradition that exists among Melanesian tribes.
has been done by keeping in mind the overall aim of the thesis: to improve the position of entrepreneurs in relation to venture capitalists and other risk financing sources (i.e. business angels and corporate venture capitalists) both before and after entrepreneurs have committed to a relationship.

4.1. Agency theory

Agency theory is one of the most utilised frameworks explaining the investor-entrepreneur relationship (Sapienza & De Clercq, 2000). Most of the articles are based on early agency theorists’ work. Berle and Means (1932) were the first to discuss the incentives and opportunistic behaviour of the non-owner managers of the company. However, Jensen and Meckling’s (1976) article is probably the most cited article relating to agency theory in the venture capital context even though they did not concentrate on venture capital in their article. Jensen and Meckling (1976) defined the concept of the principal-agent relationship as; “A contract under which one or more persons (=principals) engage another person to perform some service on their behalf which involves delegating some decision making to the agent.” In entrepreneurial finance context entrepreneurs are considered to be agents and the VCs principals (e.g. Sapienza & Gupta, 1994).

The basic idea of agency theory seems applicable in the investor-entrepreneur context and it should have explanatory power when an entrepreneur-investor relationship is analysed. Therefore, it was a natural choice to cover and include agency theory in this thesis. However, I believe that if we want to better understand the investor-entrepreneur relationship and make insights that have both academic and practical value then other theoretical approaches are needed.

Agency problems emerge for the following reasons: First, the goals of principals and agents are different. In other words, a VC is only interested in maximising the return on their investment portfolio, but the entrepreneur might be interested in receiving personal benefits from acting as a company officer and may not be as interested in increasing the value of the venture. Second, it is often difficult for principals to know what the agents are doing, which can increase the uncertainty between partners and worsen the agency problem. Third, entrepreneurs and venture capitalist have different attitudes towards risk which may lead partners to behave differently in the same situation (Eisenhardt, 1989; De Clercq & Sapienza, 2001). Due to the fact that a VC has the possibility to diversify its investment across several ventures, entrepreneurs are considered more risk averse than VCs (Bowden, 1994).

VCs’ agency problems can be divided into two: adverse selection which exists prior to the signing of the shareholder agreement and moral hazard which is the entrepreneurs’ opportunistic behaviour after the signing of the shareholder agreement (Arthurs & Busenitz, 2003). The concept of asymmetric information has been used to explain adverse selection. Asymmetric information makes it costly or even impossible for a principal to evaluate the agent’s ability and, therefore, a VC may invest in less able entrepreneurs (Akerlof, 1970). In Article FOUR we suggest that the elimination of asymmetric information is one of the main reasons for the utilisation of advisors. By using advisors, entrepreneurs are able to signal their quality towards investors. Amit et al. (1990A, 1990B) have suggested that only less able entrepreneurs are interested in VC funding, noting that in order to compensate for potential risks caused by asymmetric information, VCs may price their offers less attractively for (high ability) entrepreneurs.
Moral hazard refers to the agent’s behaviour during the relationship that is not in the principal’s interest. Barney et al. (1994) have divided the agent’s (entrepreneurs’) moral hazard behaviour during the post-investment phase into two. First, the term *managerial opportunism* is used to describe the agent’s self-seeking behaviour as a manager of the venture or their inability to perform well i.e. conduct themselves in an appropriate business manner. Examples of self-seeking behaviour could be enjoying a high salary or driving R&D projects based on personal interests. An example of the inability to perform well would be a decision to keep low performing employees in the venture. Second, *competitive opportunism* is used to describe an agent’s action to e.g. start a competing firm or act as a business consultant for the competing firm. All actions will directly or indirectly diminish the value of the principal’s investment in the venture. In addition, agency theory’s notion of opportunistic behaviour also indicates that an entrepreneur’s tendency to behave opportunistically should decrease when as ownership increases. In other words, as an entrepreneur’s ownership decreases, the likelihood of opportunistic behaviour increases (Barney et al., 1989).

Agency theory has been tested and at least partially proved in many empirical studies. For example, Sapienza and Gupta (1994) found in their research covering 51 VC-entrepreneurial team dyads that VCs can reduce the agency risk by monitoring entrepreneurs. The vehicles of monitoring are e.g. staged financing, board membership and detailed legal contract covenants (Gompers & Lerner, 1996). Manigart et al. (2002) conducted a five-country study researching the determinants of VCs’ required return. They found strong evidence that monitoring and the assistance of VCs (nonfinancial benefits) should lead to a higher returns from a portfolio company. Van Osnabrugge (2000) compared VCs’ and business angels’ investment processes. He utilised the agency theory approach in his study and found strong support for agency theory’s applicability in the VC-entrepreneurs relationship. He found that a VC tends to emphasise actions which decrease information asymmetry by conducting a detailed investment analysis and by concentrating on writing comprehensive investment contracts between VC and entrepreneurs prior to the signing of the shareholder agreement.

Agency theory, being the broadest used theoretical framework in the investor-entrepreneur context, has attracted much criticism. Cable and Shane (1997) argue that in agency theory the goal alignment between the parties consists only of monitoring activities and ownership incentives. Arthurs and Busenitz (2003) discuss the goal congruency and argue that when the principal’s and the agent’s goals are aligned agency theory is not able to explain the behaviours of the parties. Sapienza and De Clercq (2000) have even questioned the basic assumptions of agency theory in the VC-entrepreneur context. They argue that agency theory’s assumption of different and persistent attitude towards risk among VCs and entrepreneurs is not necessarily applicable since an entrepreneur’s decision to found a venture shows risk taking ability. In addition, scholars argue that a VC’s attitude to risk is likely to change as a venture develops. Hence, when the exit phase approaches, the VC is not willing to take risks which might jeopardize the exit, whereupon the VC turns risk averse. According to Article THREE it is rarely the case that investors have almost all the power during a relationship as is commonly suggested by agency theory. In fact, power fluctuates and is very dependent on the situation. Therefore, agency theory’s broad applicability may be difficult.

Agency theory also seems to concentrate on protecting investors against downside losses rather than emphasising the upside potential of investments (Arthurs & Busenitz, 2003). It is common knowledge that the majority of the VC investments will
fail in some respects. For example, Sapienza et al. (1994) conducted a cross cultural study of VC investments in Europe and estimated that 15% are great successes, 70% are living dead investments\textsuperscript{33} and the rest are total failures. However, since some investments are extremely profitable the entire portfolio should provide an adequate rate of return on their investments. Therefore, emphasising greater risk-taking and the upside potential, rather than being protected from the downside risk, might be relevant.

Agency theory has been considered to be mainly static and, therefore, it is suggested that the theory is not able to explain comprehensively the turbulent VC-entrepreneur relationship (Cable & Shane, 1997). The extant literature supports Cable and Shane's (1997) arguments, for example, Sapienza and De Clercq (2000) emphasise the complexity and volatility of the environment in which VCs and entrepreneurs operate. Arthurs and Busenitz (2003) argue that agency theory might be most applicable in explaining the behaviour of entrepreneurs immediately prior to the first investment made by the VC. Thereafter, agency concerns might erode until appearing again with some “upswing”. In addition, Cumming and MacIntosh (2001, 2003) suggest that the information asymmetry correlates with the stage of venture e.g. earlier investments are made with a higher amount of information asymmetry. Consequently the scholars' findings imply that agency theory would be more applicable during the early stages of the venture capital cycle.

The above views are supported by Articles THREE and FOUR. Agency theory provides valuable insights for the evaluation and structuring phases and, for example, advisors may be able to eliminate asymmetric information (Article FOUR) Other practical examples of the methods which a VC and entrepreneurs could use to decrease asymmetric information are e.g. the development of a prototype by entrepreneurs, a VC's detailed investment analysis (i.e. due diligence) – including market studies, interviews etc. (Amit et al., 1990A). After the shareholder agreement has been signed and a VC invests in a venture the problem of asymmetric information becomes less significant. Other viewpoints may also provide more insights than hierarchical principal-agent approach. For example in Article THREE the idea of analysing power in the relationship in more detail is promoted. According to agency theory investors are interested in whether the entrepreneur concentrates on actions which are in the investors' interest i.e. actions that increase the value of the venture and avoid actions that could be interpreted as moral hazard behaviour. The determination of moral hazard is not always easy because. An entrepreneur may decide to go on a conference trip and see it as an essential way to increase its knowledge and, hence, the success possibilities of the venture. However, the investors might consider it rather as an unnecessary cost and a private perk (Markman et al., 2001).

To summarise, agency theory can be considered to be more applicable before investors and entrepreneurs have agreed on an investment. It provides insight for efficient contracting, goal alignment and the elimination of asymmetric information. During the post-investment phase, agency theory emphasises the avoidance of moral hazard behaviour. However, several empirical studies have shown that the investor-entrepreneur relationship is more complex and that other factors exist there as well. Article THREE emphasises the role of power in the relationship. Finally, agency theory fails to emphasise the role of trust and fairness which have been shown to have very strong implications for investors and entrepreneurs as well as their relationship. For

\textsuperscript{33} Living dead investments remain alive but are not able to generate any substantial cash flow or high valuation that could provide a highly profitable exit for the investors.
example, an entrepreneur’s feedback increases the VCs’ perceived fairness, trust, decision commitment and propensity to reinvest and decreases their desire to monitor the entrepreneurs (Sapienza & Korsgaard, 1996). In addition, the VCs’ trust in the entrepreneurs is positively related to the VCs’ perception of an entrepreneur’s performance (De Clercq & Sapienza, 2006). And if VCs do not trust an entrepreneur, they will not be willing to invest more funds, time and other resources in a venture (Ryan, 1995). The pure agency theory approach disregards these findings, which means other theoretical lenses are required.

From the point of view of this thesis, agency theory, even though it can be criticised, forms a solid starting point for evaluating the investor-entrepreneur relationship. It is clear that this relationship contains agency problems. However, since agency theory has been extensively used it is unlikely to provide any major new insights that would have significant theoretical and practical value for this thesis. This is because the main emphasis of the thesis is on other insights and approaches, such as role of trust, complementary resources and the power relationship between entrepreneurs and investors. Next I will discuss other frameworks and theories.

### 4.2. Resource based view

Penrose (1959) was one of the first authors who conceptualised a firm as a collection of resources and viewed company growth as a process that utilises these resources and increases a firm’s resource base. Wernefelt (1984) built on Penrose’s ideas and defined companies as collections of resources rather than as sets of product-market positions. After Penrose (1959) and Wernefelt (1984), Barney (1991) suggested that resources are heterogeneously distributed across firms, that resources cannot be transferred across companies without a cost and that firms may be able to maintain a sustainable competitive advantage based on those factors. In addition, Barney defined firms which seek to maintain a sustainable competitive advantage as needing to emphasise resources that are valuable, rare, without corresponding substitutes and difficult for competitors to imitate.

Barney (1991) linked the resource based view to the famous SWOT-concept and suggested that an analysis of a firm’s strengths and weaknesses concentrates on the internal analysis of the firm, while the opportunities and threats concentrate on the external factors, such as the environment, market place etc. The resource based view concentrates mainly on the internal part of the firm but contains linkages to external parts as well. In other words, a firm’s strength and weaknesses are associated with resources. The more resources a firm has the more strengths and fewer weaknesses it possesses.

One of the main concepts in the resource based view is the choice to produce resources. In principle, a firm has two methods: the internal or external production of resources. The external acquisition of resources provides several advantages which are primarily associated with direct and indirect access to complementary resources (Chung et al., 2000). A broad number of studies have concentrated on this topic, especially from the recently founded, small and innovative ventures’ point of view. Similar types of firms also form the major portion of the VCs’ portfolio firms (Cooper et al., 1991; Dyer & Singh, 1998).

Bilateral needs and complementary resources provide fruitful ground for utilising the resource based view in relation to investors and entrepreneurs. Therefore, various
authors have utilised the resource based view in the investor-entrepreneur context. For example, Manigart et al. (2002) used, among other frameworks, the resource based view in their five country study of the VC context. They found that the less portfolio firms per VC investment manager the higher the required return is. In addition, specialised VCs require a higher return than unspecialised VCs. They therefore conclude that VCs believe that they create value (by advising, etc.) that is consistent with the resource based view. Cornelius and Naqi (2002) tested the resource based view by using data from Hong Kong and Singapore. Their research provided an unsurprising result: an entrepreneur's resource strength is associated with low VC involvement, while perceived resource weakness was associated with high VC involvement.

The resource based view’s basic assumption is that companies have two ways of obtaining resources (internal and external), which seems to provide a good framework, especially in a new venture setting. In addition, the framework provides insights for both investors and entrepreneurs for assessing the suitability of a partner prior to entering into the relationship. Several scholars have suggested that the selection of a partner is a very important long term decision for both VCs and entrepreneurs (e.g. Sapienza et al., 1996). In addition, Barney et al. (1996) have shown that an entrepreneurs’ assessment of the VCs’ value added varies. Correspondingly, VCs differ with respect to their assessment of risks, investment strategy, involvement level and industry area where they operate (MacMillan et al., 1985; Muzyka et al., 1996). Consequently, VCs and entrepreneurs do not always fit together, or are not an optimal match for each other, and this requires careful assessment by the parties in order to find a good fit between the partners. This phenomenon has attracted a lot of attention from the VCs’ point of view concerning the issues of how they can select the best possible entrepreneurs for their portfolio (Shepherd et al., 2000; Shepherd et al., 2003) and what the investors’ decision criteria should be (Hall & Hofer, 1993; Franke et al., 2008). The resource based view, however, can be applied from an entrepreneur’s point of view as well, even though it is not that common. In Article TWO I have analysed in detail how entrepreneurs could be selective and ensure that they would receive critical resources from investors. The Article’s approach is based on resource based view: i) entrepreneurs should analyse what resources (financial & nonfinancial) they lack and ii) if possible, they should try to find an investor that is likely to provide most of the resources that the lack. The article it highlights the fact that entrepreneurs may place too much emphasis on financial aspects and disregard nonfinancial aspects. However, as demonstrated in the article, ensuring the investors’ delivery of nonfinancial resources is very difficult as well.

Another strategy for entrepreneurs seeking critical resources from investors is the utilisation of advisors. In Article FOUR we have identified a new group of actors in the theoretical entrepreneurial finance context: advisors. These individuals are specialised in supporting entrepreneurs to acquire venture capital and they may be able to, based on their connections and experience, create better entrepreneur-investor matches. Therefore, entrepreneurs could utilise advisors in order to ensure a higher likelihood of obtaining critical resources from the investors.

An important aspect when resources are analysed in the entrepreneurial finance context is the fact that the nature of the investor-entrepreneur business makes it difficult for both parties to replace their partners when there are problems. For an investor it may be difficult or even impossible sometimes to find individuals who have similar skill sets than certain entrepreneurs and who could thus replace the
entrepreneurs. Entrepreneurs face similar problems and usually investment agreements and contract covenants prohibit or make it extremely difficult to change the investor. Therefore, it is particularly important to assess the fit of the partners beforehand.

Priem and Butler (2001) have presented broad criticism of the resource based view as an independent theory. The authors provide the following criticism. First, the resource based view is tautological and the framework is true by definition. Second, by including everything under the term “resources” the defining of the boundaries of the theory has become problematic. The resource based view argues that resources are valuable but it does not provide any methods on how to evaluate when, how and where they could be used. Third, Priem and Butler (2001) criticise the theory for being static. Barney (2001) has answered the authors’ criticism by arguing that, at a high level, all theories are tautological and also showed how the theory can be parameterised and exposed to empirical testing. Second, Barney (2001) suggests that a broad definition is more a benefit than a con and, after a resource is defined as a valuable resource, resource based view logic can be utilised in order to assess the strategic advantage of the resource. Third, Barney argues that his original work was in fact dynamic as were the former works of e.g. Penrose (1959) and Wernefelt (1984).

The resource based view’s suggestion that resources may provide a sustainable competitive advantage for a firm provides insights both prior to and after the signing of the shareholder agreement (i.e. the investment materialises and the parties start to cooperate). Partners that assess the resources through four criteria (as suggested by the resource based view): value, rareness, imitability and substitutability and can get insights both prior to and after the signing of the shareholder agreement. Prior to the signing of the shareholder agreement the resource based view can give insights about assessing the potential of the partner’s resources. In addition, since the ventures’ success depends on the use of resources the theory is also applicable after the signing of the shareholder agreement (Chung et al., 2000). In Article TWO I have promoted the idea that entrepreneurs should be selective when evaluating investors. This is likely to lead to better investor-entrepreneur “matches”. In Article FOUR we have suggested that advisors may provide considerable support for entrepreneurs in their selection of the most suitable investor for their individual needs. From an entrepreneurs’ point of view a good investor provides sufficient capital and on good terms, is potentially able to provide complementary resources and does not demand that entrepreneurs commit themselves to unfair and harsh contract covenants.

The four attributes of resources suggested by Barney (2001) could offer a valuable framework with which to assess the resources before the relationship and see how they would fit both parties’ needs, provide complementary resources and, ultimately, how they would create more value during the post-investment phase. For example, the VC’s due diligence process covers all four attributes. First, the VC evaluates whether the venture is able to provide the required return on the investment (Elango et al., 1995). Second, the VC evaluates the current environment in which the venture operates and reviews how unique the venture’s business concept is, how difficult it is to imitate it and how likely it is that the venture’s technology will be replaced by competing technology (Fried & Hisrich, 1994). Entrepreneurs should also conduct a similar kind of

34 E.g. Fiet et al. (1997) argue that the replacement of a CEO is an ineffective way to improve a venture’s performance. Bruton et al. (1997) found that the replacement of the CEO of VC-backed firms had a strong positive effect on a company’s performance. Regardless of the contradictory results, it is probable that the dismissal will cause some problems and, therefore, it would be better to choose a suitable CEO in the first place.
assessment prior to starting the relationship (Manigart et al., 2002). However, this viewpoint has not attracted that much attention. That was one key reason why I decided to launch a research project that led to Article TWO. I wanted to study, how entrepreneurs select their investors. Basically, entrepreneurs have two strategies to get value added from investors: i) before entering a relationship they should select an investor that is able to provide value added and ii) ensure that the investor is willing and motivated to provide value added during the relationship (note analogy to Baum and Silverman 2003). In the Article I have utilised Sapienza et al.'s work (1996) and presented various potential investor resources that entrepreneurs should evaluate and consider before selecting an investor (i.e. the analysis of complementary resources). Similarly, in Article FOUR, we promote the idea of advisors as a key resource for diminishing the “knowledge gap” (i.e. advisors help entrepreneurs draft a good deal).

In sum, the resource based view mainly relates to the selection and utilisation of complementary resources in the investor-entrepreneur context. VCs often have better knowledge of certain aspects (e.g. access to networks, financial knowledge) in the relationship. The same applies to entrepreneurs: They have developed a business concept, technology or other commercial opportunity that can be benefitted from, but they lack capital. Therefore, partners that complement each other may substantially increase the performance of the venture. In Articles TWO and FOUR, I have concentrated especially on analysing what key methods could ensure the transfer of complementary resources from investors to entrepreneurs. As discussed above it might be difficult to define the borders of the resource based view because defining everything under term resource the framework can be applied very broadly. However, concepts that I am going to discuss next, trust (procedural justice theory), signals (the certification effect) and different power constructs have rarely been included in resources. Nevertheless, I think that they provide important additional insights that support the aim of the thesis.

4.3. Procedural justice theory

Procedural justice theory was originally developed from equity theory (Thibaut & Walker, 1975; Sapienza & Korsgaard, 1996). Adams (1966) developed equity theory by suggesting that employees try to maintain a balance between their inputs – that they provide for their jobs – and the outcomes that they receive from the workplace. In addition, employees compare their relative inputs and outcomes with other workers. Procedural justice theory focuses on the perceived sense of justice in making decisions and the transparency of the decision-making processes. Equity theory emphasises the outcome of decisions, while procedural justice theory concentrates on the process of decision-making. According to procedural justice theory, a person who is not able to directly influence the making of decisions might rather be interested in the fairness of the decisions and the process of making them, since it could provide a method to indirectly influence the decisions (Thibaut & Walker, 1975). It has been shown that a person's perception of fairness has a significant impact on their commitment to decisions, performance, behaviour and attitudes across many different settings (Kim & Mauborge, 1991; 1993). In addition, it has been shown that factors such as trust and commitment influence an individual’s assessment of a relationship (Busenitz et al., 1997).

Tyler (1989) has identified three factors that influence an actor’s perceived procedural justice. First, standing is used to describe an actor’s status in the relationship. For example an investor that treats an entrepreneur with respect and does not force its
views to the entrepreneur is more likely to earn high respect and perceived procedural justice from entrepreneurs. Second, *neutrality* implies that a party (i.e. investor) that makes decisions behaves neutrally towards all actors (i.e. the portfolio companies) and is willing to change its view when new information comes available. Third, *trust*, relates to assurance that the decision making party behaves trustworthy and predictably. In the investor-entrepreneur context an investor that does not exploit its position in order to gain short term benefits is more likely to earn high trust and be accorded procedural justice from the entrepreneurs (Busenitz et al., 2004).

Sapienza & Korsgaard (1996) applied procedural justice theory in the VC-entrepreneur context by conducting a laboratory experiment and a field study. They found strong evidence for the applicability of procedural justice theory in the researched context. According to these scholars, procedural justice theory helps the parties to understand information asymmetry and has implications for investors and entrepreneurs. Second, it illustrates the determinants for an effective investor-entrepreneur relationship and, third, the theory gives explains how an entrepreneurs’ provision of timely feedback and investors’ influence affect the behaviour and attitudes of the parties.

On the other hand, Sapienza and Korsgaard (1996) suggest that procedural justice theory requires some refinement when it is applied in environments that are incoherent or contain nonhierarchical relationships. This implies that procedural justice theory is not fully applicable to all situations of investor-entrepreneur relationships, especially when taking into account the fact that the environment where investors and entrepreneurs operate is often very turbulent. Sapienza and De Clercq (2000) question the generalisation of procedural justice theory by suggesting that attitudes towards procedural justice could be dependent on e.g. context, situation or cultural. If the suggestion applies, it makes the practical utilisation of the framework difficult in the entrepreneurial finance context. In Article THREE, I support the view that the investor-entrepreneur relationship is not always hierarchical (note the link to agency theory) and that the relationship is constantly in flux.

In the entrepreneurial finance context in general, justified decisions are very important since they build up trust and confidence (Shepherd & Zacharakis, 2001) which are essential for an efficient and positive relationship. For example, Busenitz et al.’s (1997) major finding in a study utilising procedural justice approach and covering 201 VC financed ventures was that indiscriminate use of contract covenants can negatively affect an entrepreneurs’ perception of how they have been treated by the VC. Ultimately, this could influence the entrepreneurs’ attitude towards co-operation and, consequently, the entrepreneurs would not perceive the nonfinancial benefits provided by the VC as being as valuable as they were before and the entrepreneurs would no longer be willing to consider the VC’s advice no matter how valuable it might be.

In practice, an investor is not always able or willing to act fairly. In certain cases the dismissal of a venture’s CEO could increase the performance of the venture and, hence, the dismissal is in the investors’ interest (Bruton et al., 1997). In situations where an investor is obliged to act against entrepreneurs’ interests, procedural justice theory may provide a framework to assess the implications of decisions and to better understand the consequences of the decisions and thereby ultimately make better decisions. Entrepreneurs’ previous experience, the performance of the venture and the contract covenants that the VC includes in the investment agreement during the negotiating

35 I.e. value added elements such as access to networks, acting as a sounding board and strategy consultation.
phase influence the perceived fairness of entrepreneurs (Busenitz et al., 1997). It may be that investors’ behaviour during the negotiation phase could also influence the perceived fairness of entrepreneurs during the post-investment phase. I suggest, however, that procedural justice theory is mainly applicable after the shareholder agreement has been signed and a formal business relationship has been formed. In other words the main emphasis in ensuring that entrepreneurs perceive fairness will be related to the investors’ decisions and behaviour during the relationship, i.e. the post-investment phase. My suggestion of procedural justice theory’s applicability is at least partially legitimated by Fiet et al. (1997) who used, among other frameworks, procedural justice theory in the investor-entrepreneur context. They suggested that there are at least three ways a VC can act with a sense of fairness. First, even though a VC possesses a broad knowledge about the business of a specific venture, a VC should not behave in an authoritarian way and tell entrepreneurs how their business should be run. Second, a VC should actively compromise with the entrepreneurs. Third, a VC should emphasise an innovative atmosphere with entrepreneurs. All suggestions made by Fiet et al. (1997) are mostly valid after the shareholder agreement has been signed, implying that procedural issues are more important after the signing of the shareholder agreement. Similarly, Article THREE concentrates on post-investment phase.

In sum, entrepreneurs may perceive investors’ decisions as either fair or unfair. Procedural justice theory suggests that if an investor makes a fair and procedurally just decision it is likely to increase the entrepreneur’s motivation and it is more probable that the entrepreneur will work effectively to execute the decision, which should lead to the improved performance of the venture. The alternative would be that the investor makes an unfair decision which negatively affects the entrepreneur’s motivation and ultimately the performance of the venture (Sapienza & Korsgaard, 1996). I have utilised procedural justice theory mainly in Article THREE where I analyse the power settings between a business angel and entrepreneurs. Procedural and fair decisions and behaviour can form one important power source called “referent power” (for more information about power sources, see 4.5.). However, as suggested in Article THREE the investor-entrepreneur relationship is much more complex and it is likely that parties will encounter situations that are better explained by utilising other theoretical lenses than procedural justice theory.

4.4. Certification effect (i.e. signalling)

Both the certification effect (i.e. a respectable party certifies) and signalling (i.e. a perceivable signal that reveals something) are used as synonyms in the entrepreneurial finance literature. For the sake of clarity I will use the term certification consistently instead of signalling. However, below I will use both terms signalling and certification in the same way they were used in the original articles that I refer to. The brief signalling/certification review is mainly based on the literature review that was presented in Article FIVE.

Signalling theory concentrates on signals between individuals that are perceivable and can be used to assess the true nature of a certain hidden aspect or quality. For example, the type of a car that a person drives is a signal of that person’s wealth. Similarly, an applicant’s education and previous job experience could be used as signals of how the person might perform in a new job (Spence, 1973). In addition to humans, animals’ signals have been extensively studied (see e.g. Dall et al., 2005). Signalling (theory) has direct linkage to agency theory and the elimination of adverse selection as mentioned earlier. Signals can be used to communicate a certain quality to outsiders and, hence,
diminish information asymmetry (Akerlof, 1970). In the entrepreneurial finance context, where information asymmetry is high, signals may provide additional or sometimes the only effective method of assessing the quality of a certain company. Therefore, for example, an investors’ investment in an entrepreneurial firm can be a signal of quality to potential employees, customers, distributors or co-operation partners. In other words, it is almost impossible for outsiders to observe the true nature of a venture.

Signals, and how they certify a certain event, have often been studied in entrepreneurial finance. The main attention has concentrated on IPO pricing and the valuation of the sequential financing rounds of VC backed companies (Meggison & Weiss, 1991; Barry et al., 1990). These studies show that VCs do certify the price of initial public offerings (IPOs). In other words, VC backing has been shown to lead to lower post-IPO price performance, consequently lowering the total cost of going public and increasing the higher net proceeds for a firm going public. In addition, certification has been utilised in the VC-entrepreneur context, to test how an entrepreneur’s initial investments signal quality and the long-term performance of the venture. However, Busenitz et al. (2005) failed to find such an association. Prasad et al. (2000) showed that business angels could utilise the proportion of an entrepreneur’s wealth invested in a venture as a signal and decision criteria. However, I suggest that the certifying effect could be much more extensively applied in the entrepreneurial finance context. The certifying effect can be considered to have most importance when information asymmetry is especially high i.e. in the seed and start-up phases of ventures, not when firms are preparing for their IPOs (Seppä & Maula, 2001). These early stage firms are often short of employees, additional finance, partners, customers and suppliers and are lacking other critical resources (Lichtenstein & Brush, 2001). Therefore, an independent party with high reputational capital that invests in a venture may signal to outsiders that the firm is credible.

Meggison and Weiss (1991) and Booth and Smith (1986) suggest that in order for the certification to be credible three criteria need to be met in a certification event36. First, the certifying agent needs to have his/her reputational capital at stake. In the entrepreneurial finance context an unsuccessful investment provides considerable disadvantages for the VC. In practice, unsuccessful investments have at least three negative consequences for VCs: First, their compensation is based on investing in successful ventures. VCs and limited partners share part of the portfolio’s return - typically a VC’s share of “carry” is 20% (Sahlman, 1990). Second, making unsuccessful investments may make it more difficult to raise additional VC funds from limited partners (Barnes & Menzies, 2005). Third, it may be more difficult to attract the best possible investment candidates if a VC is not able to show a consistent track record of backing successful investments. The second criterion is that any one time wealth transfer for a certifying agent cannot exceed the reputational capital at stake. VC business does not operate on the going concern principle, instead VC funds have a limited lifespan (often 10 years). A VC that would provide false certification signals might seriously harm its attempts to raise additional funds and it is unlikely that any onetime benefits of false certification would exceed this. The third criterion of a credible certification event, is that it is costly to receive certification from the agent. In other words, entrepreneurs that get VC investors should “pay” for the VCs’ involvement. In the VC literature, it is a broadly acknowledged fact that VC funding is a

36 Even though it would be possible to develop similar taxonomy for business angel funding and corporate venture capital by taking into account the individual differences and characteristics of those funding methods I have concentrated here and in Article FIVE only on professional venture capital.
very expensive funding mechanism for entrepreneurs (see e.g. Sahlman, 1990), therefore this third criterion also applies.

In sum, signals and certification are applicable methods for evaluating a certain quality or entity when information asymmetry is high. Therefore, it is surprising that they have attracted so little attention in the entrepreneurial finance literature. Early stage firms continuously encounter credibility problems, so outside certification should provide high rewards. I have mainly utilised certification hypothesis in two Articles. In Article FOUR we argue that advisors actually certify venture capital investments and, hence, increase the likelihood that entrepreneurs that utilise advisors are more likely to acquire funding and/or get it with better terms. In other words we identify a new certifying agent – advisors. In Article FIVE I have tried to expand the analysis of certification from later stage to early stage ventures, although earlier attention concentrated on exiting and IPOs, apart from a few papers. In Article FIVE I have tried a new data source i.e. business press news articles and analysed how media attention changes after VC investment. In other words I have demonstrated that the certification effect applies to very early stage firms as well.

4.5. Power constructs in entrepreneurial finance

It is surprising how little power has been discussed in the entrepreneur-investor studies –the relationship between the parties is commonly of interest but the power elements are mostly neglected. Still, after an investor has invested in a venture and the parties start to interact it is likely that power in one form or another influences the relationship. While power is determined as the ability to “get others to do things they would not otherwise do” (Baldwin (1980, p. 501) this is common in investor-entrepreneur relationships. It is also common that both parties in a relationship may end up in situations are not 100% willing to do something. However, the power of the other party makes them act in ways they do not want to. Good examples are contract covenants that provide (usually for the investor) the right to make certain kinds of decisions that will strongly influence an entrepreneurs’ situation as well (the trade sale of a venture, the dismissal of entrepreneurs, other veto rights etc.). Control, on the other hand, has mostly been studied in the entrepreneur-investor context. For example, Isaksson et al., (2004) have studied different contract covenants that are utilised in VC-entrepreneur contracts in Sweden. Kaplan and Strömberg (2003) used U.S. data and analysed the allocation of different rights between investors and entrepreneurs. Power that is based on contracts is often called legal power. In Article THREE, I illustrate that there are various other power sources – in addition to legal power, which can be used through contract covenants. The other power sources are coercive, reward, expert and referent power. (French & Raven, 1959; Emerson, 1962; Casciaro & Piskorski, 2005). Below I will briefly describe the different power sources. A more detailed presentation is presented in Article THREE.

- Coercive power refers to the more powerful actor’s use of coercion as a power source, with possibly severe consequences for one who does not follow the more powerful person’s lead.

- Reward power refers to the more powerful person’s possibilities to reward the other party.
• Expert power relates not to a person’s formal position and the power that it bestows, but to the person’s knowledge and expertise which others consider valuable.

• Legal power relates to an actor’s legal position.

• Referent power refers to situations where a skilful user of such power gets people to do things without recourse to using force, expertise or a formal position.

In the entrepreneurial context Fischer and Pollock (2004) studied VC backed firms’ IPO processes and failures. The authors studied whether VCs’ higher ownership (i.e. the power to control a firm) would lead to a lower probability of failure. However, this hypothesis was not supported. However, when a CEO and VC together own a fairly equal number of shares or the founder-CEO owns a substantial share of his/her floated firm, its probability of failure decreased. Fried and Hisrich (1995) conducted a case study of 14 VC-entrepreneur dyads in the U.S. According to the authors VCs have three methods for influencing entrepreneurs i) money, ii) personal relationships and iii) formal power. The VCs’ formal power becomes more significant in the later stages (i.e. as a company becomes more established, rather than with start-ups).

In this thesis and particularly in Article THREE I have analysed and discussed the applicability of power and dependency, power balance/imbalance and sources of power, i.e. coercive, reward, expert, legal/position and referent power (French & Raven, 1959; Emerson, 1962; Casciaro & Piskorski, 2005), in the investor-entrepreneur context. Based on my analysis, power constructs are constantly present in the relationship and they influence investor and entrepreneur behaviour. Power is also a more complex construct in the entrepreneurial finance context than Fried and Hisrich (1995) have suggested. Contrary to their propositions, I suggest that it is not always the investor who has the power. Entrepreneurs have power that is drawn from different power sources, such as legal and expertise power. Constructs, such as dependency, power balance/imbalance, and different power sources, influence the behaviour of the parties and could help us to understand the relationship between entrepreneurs and investors more completely.

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37 See Article THREE and particularly scenarios two and three in pages 51 and 61). I was not aware of Fischer and Pollock’s (2004) article while I published Article THREE. However, the author’s findings partially confirm my suggestions and can be presented utilizing the taxonomy that was introduced in Article THREE (figure 1).
5 SUMMARY AND MAIN CONTRIBUTION OF THE ARTICLES

Below the background of the Articles (timeline, where the research idea came from, how the paper has developed over the years, why a certain research approach/method was selected, what kind of feedback I have received over the years) is presented. In chapter 7 I discuss the validity and reliability of the Articles and the thesis in general.

5.1. Article ONE: An Entrepreneur’s Guide to the Venture Capital Galaxy

While on a research visit to the U.S., I got, at least partially by coincidence, into a research project that led to *Academic of Management Perspectives* publication “An Entrepreneur’s Guide to the Venture Capital Galaxy”. The purpose of the project was to sum up what we know about venture capital, business angels and corporate venture capital funding. We wanted to provide an alternative to and update Zider’s (1998) HBR article on venture capital financing. We selected a process view for our Article and discussion regarding how investor types differ and have similarities during various phases of the investment cycle from an entrepreneur’s point of view. The entire writing and editing period lasted from the beginning of 2005 to summer 2006, including various additions and editing suggested by referees and the editor.

The end product is a compact presentation that contains several illustrative tables that help to present a vast amount of information in a readable manner. From my thesis’s point of view, this general presentation of the VC business offers a good basic literature review and introduction to the research area. The paper went through an extensive review process and during that process we included additional references and edited the material to make it more readable. In general, however, our original idea of providing entrepreneurs a complete source of information about professional venture capitalists, business angels and corporate venture capitalists utilising VC cycle approach is clearly present in the Article. However, due to its purpose (a summary aimed at MBA students) Article ONE does not offer a critical view on the extant literature. The identification of existing research gaps and areas of contention are dealt with in the other Articles (TWO, THREE, FOUR and FIVE). On the other hand, the Article approaches the phenomenon from an entrepreneur’s point of view, which is central in my thesis and offers a compact presentation of the field the thesis examines. Hence, the reasons for including it in the thesis are well founded. Table 3 summarises the key aspects of Article ONE.

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39 Meaning that investors’ and entrepreneurs’ relationship starts, develops and terminates in a fairly similar manner: It contains phases such as deal origination, screening, evaluation, structuring, post-investment activities and eventually exit.
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<tr>
<td>Aim of the article and linkage to the aim of the thesis</td>
<td>Summarise what we know of venture capital, business angel and corporate venture capital funding. Main target group: MBA students in the U.S. The Article provides a good starting point for the theme of the thesis.</td>
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<td>Data and research method</td>
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<td>Article has practical approach but common theoretical frameworks, such as agency theory, resource based view and procedural justice theory, are “under the surface” in the article.</td>
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<td>Practical contributions</td>
<td>A compact presentation of venture capital investing mainly for practitioners and academics. The Article summarises much information and offers a good starting point with which to examine venture capital investing.</td>
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Table 3  Key facts of Article One.

5.2. Article TWO: Multiple Case Study of Entrepreneur’s Venture Capital Investor Selection Process

My first research project started in 2004. I conducted most of the interviews with various entrepreneurs that had raised venture capital and corporate venture capital funding from Finland, Sweden, the U.S., the U.K. and Germany during early summer 2004. For Article TWO, four entrepreneurs were selected. The case companies were located by using convenience sampling. I had met two of the entrepreneurs earlier and I had previous knowledge of all case companies since I had followed their development in media after they had acquired VC funding.

The entrepreneurs were interviewed at least twice, including focus group meeting in which three of the four lead entrepreneurs participated. I followed Eisenhardt’s (1989) case study protocol, including the collection of background information: a pilot interview was conducted in order to test the research method and structure, interview data were recorded and transcribed, interviewees were contacted afterwards in order to clarify unclear aspects. First within-case analysis was conducted and then it was broadened to a cross-case analysis. Considering the fairly small Finnish venture capital scene (Lahti, 2008), four case studies were estimated to provide a sufficient picture of the business in Finland. As in case studies generally, the main purpose was to evaluate in depth a small number of cases rather than increase the number of cases. After data collection, several drafts were written. Eventually in 2007 a conference paper was presented in EURAM 2007 in Paris. My initial plan was that I would prepare a manuscript-based thesis and these interviews would act as partial data for the project.

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However, along the way I realised that there are related aspects in the investors-entrepreneur relationship that attracted my attention but did not fit well with the manuscript strategy. Therefore, pretty soon I diverted my attempts to writing an article-based thesis.

The key finding and propositions of Article TWO are that the selection process entrepreneurs have for finding investors may have a considerable impact on the future success of the venture and should be of interest to entrepreneurs. Traditional venture capital research has extensively discussed the value added that venture capitalists bring to entrepreneurs (see e.g. Arthurs & Busenitz, 2003; Busenitz et al., 2004; Fernhaber et al., 2009). In short, it has been suggested that investors provide, in addition to funding, other positive nonfinancial resources for entrepreneurs (i.e. value added). In situations where entrepreneurs may benefit from these value added actions that investors can potentially provide, it is crucial to study how entrepreneurs can increase the likelihood of obtaining these nonfinancial resources. Extant research emphasises that the transfer of nonfinancial resources is associated with high trust between parties (Arthurs, & Busenitz, 2003; De Clercq & Sapienza, 2006; Shepherd & Zacharakis, 2001). However, another method could be that entrepreneurs select a suitable investor that is capable of providing nonfinancial benefits or that entrepreneurs should first select a suitable investor and after that emphasise trust between parties (during the post-investment phase).

Surprisingly, extant research lacks the ability to fully analyse the situation from an entrepreneur’s point of view and the emphasis on the selection of investors by entrepreneurs is disregarded. Therefore, I promote the idea that also entrepreneurs should select their investors. I acknowledge the fact that this is not always possible, but when it is possible I analyse what kind of aspects entrepreneurs should pay attention to and evaluate. In the Article I utilise Sapienza et al.’s (1996) framework and I suggest that it could actually form a good basis for a check list of potential non-financial value added that investors could provide for entrepreneurs. In addition, I present a tentative model for the selection and decision criteria when choosing investors (see figure 1 on Discussion section of the Article ONE).

In the article, I argue that entrepreneurs should identify the most relevant non-financial value added components that they lack and analyse whether an investor is able to provide these resources for entrepreneurs. I suggest that the more competent the entrepreneur, team and business concept is, the more likely it is that they will have a realistic chance of making investors compete against each other. Gompers and Lerner (2000) have demonstrated, for example, that when inflows to VC funds are high valuations also tend to increase. Therefore, a selective and skilful entrepreneur may also benefit from such VC markets trends when negotiating with VCs.

A somewhat discouraging fact is that none of the four Case Companies were especially successful in selecting their investor. On the other hand this is a signal that a lot of additional research is needed in order to fully model and understand entrepreneurs' decision making and the selection of the investor process and the underlying factors that influence these. From a theoretical point of view, the Article promotes the idea that more than trust between investors and entrepreneurs is needed, if entrepreneurs are to ensure that they get nonfinancial value added from the investors. In addition, the

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41 It should be noted that Sapienza et al. (1996) themselves state that: “As venture capitalists do, entrepreneurs should put effort into selecting investment partners, and after selection, into development productive exchange relationship with them.” In other words, they already promote the idea of entrepreneurs selecting investors, even though they do not really concentrate on the issue.
article analyses how entrepreneurs could ensure that they get the best possible investor and define the circumstances in which the selection of an investor is possible as well as suggest what the consequences of investor selection might be.

The theoretical framework that I mainly utilise in Article TWO is the resource based view. The general idea of the resource based view is that, investors and entrepreneurs may provide complementary resources for each other. Approaching the phenomenon from the point of view of an entrepreneur I suggest that they should carefully evaluate what resources they lack before approaching investors. The more critical the resources the entrepreneur lacks but which the investor is willing to provide, the better the relationship will be for both sides. In addition, I discuss agency theory and the concept of asymmetric information in the Article. However, I approach the phenomenon from a somewhat untraditional viewpoint. Commonly it is suggested that it is impossible for investors to fully evaluate the quality of an entrepreneur (Amit el al. 1990A: 1990B). I suggest that it is also impossible for entrepreneurs to evaluate the quality of investors and ensure the delivery of nonfinancial resources after the relationship has been formed. The situation where entrepreneurs are referred to as principals and investors are referred to as agents is sometimes called reversed agency theory approach (Repullo & Suarez, 2002). In table 4 I summarise the key facts of Article TWO.

<table>
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<tbody>
<tr>
<td><strong>Aim of the article and linkage to the aim of the thesis</strong></td>
<td>To study and analyse entrepreneurs' investor selection process, its consequences and the identification of key factors that influence the process. In relation to the aim of the thesis, the review demonstrates that there exists a research gap. It also aims to study how entrepreneurs select investors. The selection of a suitable investor is a key element in improving the position of entrepreneurs in relation to investors.</td>
</tr>
<tr>
<td><strong>Data and research method</strong></td>
<td>Multiple case study of four entrepreneurs that were all interviewed at least twice (including focus group interviews). Research followed Eisenhardt’s (1989) case study protocol.</td>
</tr>
<tr>
<td><strong>Theoretical frameworks</strong></td>
<td>Resource based view</td>
</tr>
<tr>
<td><strong>Theoretical contributions</strong></td>
<td>Relates to extant research that highlights the importance of the nonfinancial value-added benefits investors bring and offers a new viewpoint by analysing how entrepreneurs could ensure that they get the best possible investor (and not the other way around). In addition, the Article analyses those circumstances in which it is possible for an entrepreneur to select an investor. It also examines the consequences of the selection of investors.</td>
</tr>
<tr>
<td><strong>Practical contributions</strong></td>
<td>The article lists (in table III) a practical list of potential value added components that entrepreneurs can compare against any potential investor.</td>
</tr>
</tbody>
</table>

Table 4  Key facts of Article TWO.
5.3. Article THREE: Case Study of Power between Entrepreneurs and an Investor\textsuperscript{42}

Article THREE began when I was offered an investment opportunity in a start-up, and eventually I agreed to invest a small amount in the venture. During the involvement period with the entrepreneurs I kept detailed records and analysed the involvement, cooperation and other relevant aspects of the relationship for academic research purposes. The interaction period started in summer 2004 and had ended by December 2005. My approach was fairly unconventional since the participant observation method is rarely utilised when studying the investor-entrepreneur relationship (see Silva, 2004 as an exception). For me it provided a unique opportunity to collect data and analyse the relationship in detail. When I started the project I was not sure what the final aim, research question(s) and theme of the Article would be. This is commonly the situation in participant observation studies (Arnould & Wallendorf, 1994; Barnes, 1996). However, fairly soon during the observation period I started to become interested in the power aspects of the relationship\textsuperscript{43}. Power, defined as the ability to “get others to do things they would not otherwise do” (Baldwin, 1980, p. 501), is highly relevant in an entrepreneur-investor relationship. It is likely that both parties may be in the situations where they are not 100% willing to do a certain action. Therefore, a more detailed analysis of where power lies in the relationship is well founded. An early version of the Article was presented at the Academy of Entrepreneurial Finance conference 2006, in Los Angeles. After feedback, a revised version was submitted, revised and finally accepted for publication in the Journal of Entrepreneurial Finance and Business Venturing in 2006.

The key finding of the paper is the identification and analysis of power aspects of the entrepreneur-investor relationship. As has been emphasised in my thesis, extant research has concentrated on explaining their relationship by utilising i) agency theory; the “principal-agent” approach, ii) the resource based view; “complement resources” and iii) procedural justice theory; “trust between partners”. In addition, a few isolated articles have been published utilising, for example, prisoners’ dilemma (Cable & Shane, 1997) and other game theories (see e.g. Elitzur and Gavious, 2003). The concept of power has been extensively studied in management. Therefore, I believe that it would be well founded to study power concepts in the investor-entrepreneur context in more detail as well. The Article promotes the idea that various power constructs such as dependency, power balance/imbalance and different power sources (i.e. coercive, reward, expert, legal and referent power) all influence the entrepreneur-investor relationship. The parties’ proportional power may vary across time, the development phase, and according to the situation of the venture. In addition, I suggest in the Article that an optimal situation for an entrepreneurial venture would be that power is rather evenly distributed between investors and entrepreneurs. An interesting and relevant future research avenue could be to link their power constructs (that has not been extensively studied) with more research on venture capital constructs, such as nonfinancial contributions and trust in the relationship. Eventually, the combination could lead to a better understanding of the relationship, which could, in turn, lead to more successful investments and entrepreneurial ventures. However, based on a single case study, it is impossible to credibly argue this. Therefore, this might be a very


\textsuperscript{43} I have written another article utilizing the same participant observation data that is not included in the thesis (see Lehtonen, 2008).
interesting and relevant future research avenue. I sum up the key details of Article THREE in table 5.

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<tr>
<td><strong>Aim of the article and linkage to the aim of the thesis</strong></td>
<td>Utilise power constructs (dependency, power balance/imbalance, power sources) and analyse their applicability in the investor-entrepreneur relationship. Power constructs are extensively studied in the management and organisation literature. However, in entrepreneur-investor relationships power aspects are rarely analysed. However, the ability to “get others to do things they would not otherwise do” is a very common situation in the investor-entrepreneur relationship as well. Therefore, utilising and analysing the applicability of power constructs in this setting is well founded. Related to the aim of the thesis is the requirement to thoroughly understand the investor-entrepreneur relationship. Thus, power constructs provide an important and rarely studied new viewpoint for the theme.</td>
</tr>
<tr>
<td><strong>Data and research method</strong></td>
<td>Participant observation study of one investor-entrepreneurial team relationship for a period of 18 months.</td>
</tr>
<tr>
<td><strong>Theoretical frameworks</strong></td>
<td>Resource dependency theory, power sources (coercive, reward, expert, legal and referent power) and power balance/imbalance. In addition, for example, agency theory has been utilised to explain the investor-entrepreneur relationship.</td>
</tr>
<tr>
<td><strong>Theoretical contributions</strong></td>
<td>Offers Weak “evidence” (based on a single case study) that power constructs could be applicable and consequently provide additional insights into the investor-entrepreneur relationship. They may this relationship more effectively and broadly than, for example, agency theory (emphasis on hierarchical principal-agent relationship) or procedural justice theory (emphasis on trust).</td>
</tr>
<tr>
<td><strong>Practical contributions</strong></td>
<td>Concretive presentation of various power sources, how to get and maintain power from both the investors’ and the entrepreneur's point of view.</td>
</tr>
</tbody>
</table>

Table 5  Key facts of Article THREE.
5.4. Article FOUR: The Role of Advisors in Venture Capital Investment Process

The fourth Article is a good example of how my Articles are linked to each other: When I conducted interviews for Article TWO I came across the phenomenon of advisors that could help entrepreneurs acquire venture capital funding. Before these interviews I was not aware that such entities could help entrepreneurs in any other way than in the drafting of good legal documents. Two quotes from my interviews (related to Article TWO) illustrate my point that potentially entrepreneurs could benefit greatly by utilising advisors while approaching, selecting and negotiating with investors.

“We carefully evaluated different VC syndicates (from various term sheets that they had received) and decided to go for lowest valuation but the biggest names. We made for example a SWOT-analysis of all competing groups. When the deal was made we got four of world's five biggest corporations as our investor”

“We already had Nokia as a major customer, therefore we did not need them as an investor to increase our contacts in the organisation. Instead we wanted to increase our sales in Ericsson. However, getting Ericsson to invest in us might have disturbed Nokia and, therefore, we wanted to use a more indirect strategy. With the help of our advisor we created a plan and approached one of Ericsson's major shareholders Investor AB and convinced them to invest in us. This was a perfect solution for us. We still had Nokia as a happy customer but also we considerably increased our contact with Ericsson and they had more incentive to co-operate with us.”

Due to these events, I started to study advisors in more detail. To my surprise, only very little had been written about them in the academic venture capital literature. Therefore, I proceeded with the idea of studying how advisors actually operated. From a theoretical point of view, I started my analysis from the two main theoretical frameworks of my thesis i.e. agency theory and the resource based view. This lead to a more detailed evaluation of one specific determinant of agency problems: asymmetric information. I discovered that advisors may actually diminish asymmetric information in their negotiation process with investors. Advisors commonly pre-screen entrepreneurs and advisors’ success depends on whether they are able to obtain capital for their clients (success fee). Therefore, an advisor’s commitment to obtaining capital for one individual entrepreneurial team could be seen as a signal of quality and may diminish the investors’ asymmetric information. In addition, in the review process, we encountered the concept of investment readiness (i.e. how competent entrepreneurs are at presenting their business proposal in an effective manner for investors) (Mason & Harrison, 2001, 2004). We concluded that advisors may greatly improve entrepreneurs’ investment readiness by coaching entrepreneurs how to present their business, how to write a “correct” business plan, what are the key facts that interest investors want and what are “red flags”. In addition, advisors may evaluate entrepreneurs and advise entrepreneurs about which investors may be able to provide

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45 As suggested by Amit et al. 1990A and Amit et al. 1990B only less able entrepreneurs are interested in VC funding. According to the authors, in order to compensate for potential risks caused by asymmetric information, VCs may price their offers less attractively for (high ability) entrepreneurs.
the best match in terms of involvement and nonfinancial value added. In other words, the resource based view and the notion of complementary resources explains the operating procedures of advisors quite well.

I started with a semi-structured interview protocol that I tested with one lawyer that had extensive experience in interacting with VCs and entrepreneurs. After his feedback I approached six advisory firms that operated in Finland and interviewed five of them. Based on these interviews I wrote a paper and presented it at the 29th ISBE conference in Cardiff, 2006. The paper got positive feedback. After the seminar I submitted my paper to *Venture Capital - An International Journal of Entrepreneurial Finance* and got a revise and resubmit reply that was based on three referees’ opinions. The referees for example suggested that I should also include entrepreneurs’ opinions in the analysis and cover a few additional points on the analysis of advisors. Due to these suggestions additional interviews were needed and I agreed that Lahti should join the project as second author. In co-operation with Lahti we edited the Article and it was published in 2009 in *Venture Capital*.

The key finding of the Article is that advisors can have dramatic consequences for the acquiring of capital process. They potentially decrease the time that it takes to acquire funding, improve terms and valuation and positively affect the post-investment relationship. We recommend that most of the entrepreneurs strongly consider utilising advisors while acquiring VC funding. Only very experienced entrepreneurs might want to acquire funding without professional help. However, even they probably need help in drafting legal documents. In addition, the defining and identification of advisors in the process between investors and entrepreneurs is also a significant addition to the extant research. Earlier the relationship has been predominantly illustrated as a dyad and affected various descriptions and theoretical models. For example agency theory concentrates on the dyad of investors and entrepreneurs. However, Article FOUR reveals that potentially there is one important party that will at least influence the dyad. In addition, in the entrepreneurial finance literature, the role of trust and having a trusting relationship has been extensively studied and its importance has been demonstrated (Ryan, 1995; Harrison et al., 1997; Arthurs & Busenitz, 2003; De Clercq & Sapienza, 2006). An experienced advisor may support entrepreneurs in their development and maintain a good relationship – based on trust – with investors. Hence, the role of advisors should be more carefully analysed and included in the analysis of the investor-entrepreneur relationship. Article FOUR’s key facts are presented in table 6.

**Aim of the article and linkage to the aim of the thesis**

The article studies the role of advisors in the venture capital investment process and analyses their implications for research and practice (i.e. operating procedures and benefits – particularly for entrepreneurs). The common entrepreneurial finance literature describes the entrepreneur-investor relationship as linear and bilateral. However, it was discovered that advisors may influence the relationship. In this article, the role of advisors, operating procedures and their influence on different parties are analysed.

The description of advisors’ operating procedures and the analysis of their role contribute directly to aim of the thesis. Potentially advisors are able to significantly improve the position of entrepreneurs.

**Data and research method**

Multiple case study of five Finnish advisor firms, four VCs and three entrepreneurs. Research followed Eisenhardt’s (1989) case study protocol.

**Theoretical frameworks**

Mainly agency theory (asymmetric information), investment readiness and resource based view.

**Theoretical contributions**

Identification and defining of a new actor has implications for the previously assumed investor-entrepreneur dyad. In addition, the role of advisors as an actor that eliminates asymmetric information and improves investment readiness are also key contributions. An advisor’s operating procedure and particularly their evaluation of a good match between investors and entrepreneurs supports the utilisation of resource based view.

**Practical contributions**

Very significant implications for entrepreneurs that acquire funding; advisors may increase valuation and/or improve investment terms, diminish the time that it is required to acquire funding as well as help to select an investor that is better matched with an entrepreneur’s nonfinancial needs.

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**Table 6  Key facts of Article FOUR**

5.5. **Article FIVE: Certification Effect of Venture Capitalists.**

Article FIVE is a good example of how I have identified gaps in current venture capital research.

The literature on what value added VCs bring to an entrepreneur’s existing research cannot agree on whether VCs are really able to provide value added or not, what is the context when value added would materialise, does value added depend on the research

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46 The paper presented in RENT 2006 (Lehtonen, 2006).
period, data, method or some other factor (see e.g. Busenitz et al., 2004). However, investor value added is one of the most relevant questions in venture capital investing and has obviously attracted a lot of researcher attention. I became interested in one component of value added, which has been commonly separated from other nonfinancial value added factors, called signalling or the certification of VCs (see figure 10 where the various contributions from investors and entrepreneurs are illustrated). It seemed to make perfect sense that when “an outsider” that is known for its very selective investment strategy (as investors in general and VCs in particular are) invests, this should be a sign of credibility for outsiders47. Consequently, one could think, that this should have a positive effect on the venture’s other actions as well (e.g. attract interest from potential employees, potential customers, commercial partners and creditors). However, It is, case dependent as to how significant and relevant the certification is for a venture, although it is possible to argue that while the value adding process is potentially a series of disturbance factors the “certification benefits” (as opposite to nonfinancial benefits) are much more straightforward and easier to comprehend for entrepreneurs. When this logic was clear to me, I started to study how this certification effect has been analysed in the investor-entrepreneur context. Soon it became evident that vast majority of studies in the domain were related to IPOs and stock market returns (Barry et al., 1990; Megginson & Weiss, 1991). This is probably due to the reason that it is relatively easy to get data from the stock market and conduct an analysis comparing e.g. a venture capital backed firms’ market performance with other listed firms.

Figure 10 Main concentration area of Article FIVE: Certification.

I wanted, however, to try to analyse how investors’ certification influences much earlier stage firms that have acquired maybe their first 50,000 € or 300,000 € of seed funding. It was challenging to develop a measurement method that could credibly measure how a VC investment influences a venture’s credibility. For example focus group interviews and experiments might have been able to provide some answers. However, the best measure that I was able to develop, find the data for and execute with my resources was the publicity of ventures prior to and after VC investment in terms of business press articles. I collected data 720 days prior to and after the VC investment event. The event dates were retrieved from VCs’ internet sites. According to my analysis, the media coverage of VC backed firms increased extensively after VCs invested in a venture. From theoretical point of view, I have created a measure, tested it and showed that certification is applicable in the very early stages of VC backed firms as well. Going back to the certification/signalling literature, there are no suggestions that

47 See chapter 4.4 for theoretical explanation of certification effect.
the certification effect should only be applied to later stage firms. However, the practical utilizations of the certification effect on early stage firms were really limited. I was able to demonstrate in practice that certification is also applicable in the early stages of the VC-entrepreneur relationship. This is a relevant addition to existing research and provides additional evidence on how entrepreneurs can benefit from obtaining venture capital.

Finally regarding Article FIVE, I have not extensively studied what issues the initial publicity arose from and how the media received information regarding a successful funding round (since my assumption is that the funding round certifies the venture). However, I did conduct a survey as to whether VCs encouraged their portfolio firms to be active in publishing this information. Only 3 out of 31 respondents reported that VCs had encouraged them to actively report the investment, therefore it would seem that VCs are not main reason for the increased media attention. In addition, I compared the publicity given to non-VC backed firms during the same period than my case companies. The publicity of non-VC backed firms did not change during that period. The key facts of the Article are summed in table 7.
Aim of the article and linkage to the aim of the thesis

The certification effect of early stage ventures that receive VC funding was analysed. Previous research demonstrated that the certification effect applies to listed VC-backed firms. However, the certification effects may be much more important for early stage firms. The article assumes that increased certification is something that ventures in general consider positive.

The article relates to the aims by highlighting the fact that VC funding is likely to improve a venture’s media attention in terms of increased publicity, although there is not that much difference in what kind of VC investor invests in the venture (i.e. “top-level VC” vs. “other VC”).

Data and research method

Finnish entrepreneurial firms that had received VC funding. Survey and press articles in which firms were mentioned were often utilised in statistical analysis. In addition, the content analysis of the press articles was conducted.

Theoretical frameworks

Certification effect (i.e. signalling)

Theoretical contributions

The article validates and proves that the certification effect is beneficial for very early stage firms. In addition, the article promotes the utilisation of a fairly unique data source i.e. press articles for research purposes in entrepreneurial research.

Practical contributions

The article measures and demonstrates that VC investing is likely to increase the credibility of early stage firms, which are those that most often need credibility. Understanding investor certification can change how entrepreneurs evaluate investment offers and how investors can make their investment offers appear more lucrative.

Table 7  Key facts of article FIVE.

5.6. Summary of the Articles

Table 8 presents a summary of all five articles.
<table>
<thead>
<tr>
<th>Name</th>
<th>Short Abstract</th>
<th>Data &amp; methods.</th>
<th>Status</th>
</tr>
</thead>
<tbody>
<tr>
<td>A1: An Entrepreneur’s Guide to the Venture Capital Galaxy</td>
<td>An overview is given of several aspects related to entrepreneur – venture capitalist relationships</td>
<td>No data, literature review of relevant previous literature</td>
<td>Published: De Clercq D. Fried V. Lehtonen O. &amp; Sapienza H. 2006. The Academy of Management Perspectives vol. 20 p. 90-112</td>
</tr>
<tr>
<td>A2: Multiple Case Study of Entrepreneur’s VC Investor Selection Process</td>
<td>Multiple case study of entrepreneurs’ venture capital selection process.</td>
<td>Interviews and focus group interview among four Finnish case companies and the utilisation of case study methodology.</td>
<td>The paper was presented in EURAM 2007 conference and is submitted to International Journal of Entrepreneurial Behaviour &amp; Research</td>
</tr>
<tr>
<td>A3: Power between Entrepreneurs and Investors: A Case Study</td>
<td>Offers new viewpoints to analyse the investor-entrepreneur relationship by utilizing power constructs such as; dependency, power balance/imbalance and different power sources.</td>
<td>Participant observation methodology and data from author’s 18 months observation period as a BA.</td>
<td>Published: Lehtonen, O. 2006. Power between Entrepreneurs and Investors: A Case Study. The Journal of Entrepreneurial Finance and Business Ventures. Vol. 11 issue 1. p. 51-77</td>
</tr>
<tr>
<td>A4: The Role of Advisors in Venture Capital Investment Process</td>
<td>Provides evidence and discusses the implications for advisors that help entrepreneurs to acquire VC funding.</td>
<td>Multiple case study of five Finnish advisor firms, four VCs and three entrepreneurs.</td>
<td>Published: Lehtonen O. &amp; Lahti T. 2009. The role of advisors in the venture capital investment process. Venture Capital - An international journal of entrepreneurial finance vol. 11 p. 229-254</td>
</tr>
<tr>
<td>A5: Certification Effect of Venture Capitalist</td>
<td>I examine VCs’ certification effect in terms of publicity of portfolio firms before and after VC investment.</td>
<td>Event study and data from Finnish online news databases Kauppalehti and Taloussanomat</td>
<td>Presented in 20th RENT conference</td>
</tr>
</tbody>
</table>

Table 8  Summary of the Articles.
6 POSITIONING OF THE THESIS

In this chapter I position my thesis. First, I will utilise the venture capital cycle approach (Tyebjee & Bruno, 1984) that illustrates the process of how the entrepreneur-venture capitalist's relationship evolves from first contact to a working relationship and eventually to exit. I illustrate how my five Articles concentrate on different parts of the VC cycle (see figure 11). Second, I will utilise Cornelius and Persson's (2006) presentation of the most cited authors in venture capital research. I have compared the authors’ list of the most cited authors among VC research with my citations in the five articles (see table 9). The analysis helps classify the thesis into a management oriented research category (as opposed to a finance oriented strategy). Third, I show how the articles can be mapped by utilising different research strategies (experiment, survey, case study, action research, grounded theory, ethnography and archival research). The main target of this chapter is to demonstrate that there are various view points, discussion streams and approaches that can be utilised for the positioning of a thesis. At the end of this chapter I present a summary of the positioning.

6.1. Positioning of the Articles among venture capital cycle

In figure 11, I have illustrated how the articles relate to the VC cycle (Tyebjee & Bruno, 1984). The basic idea of a VC cycle approach is to illustrate the causal interaction between entrepreneurs and investors. First, the investors and the entrepreneurs meet, then the VCs analyse whether the entrepreneurs' business is suitable for higher level investor involvement. The idea is to eliminate clearly unsuitable business propositions as early as possible in order to avoid unnecessary work. Next comes evaluation, deal structuring and sometimes an investment takes place. Then the parties start to cooperate. During the co-operation (post-investment) phase, their cooperation should increase the valuation of the venture. Cooperation should lead to exit commonly approximately 2-6 years after the investment. In figure 11 I have added two squares that illustrate the moments when an investment and an exit take place.

Article ONE's main idea is to cover the entire VC investment process and actually we present an alternative, more detailed presentation of Tyebjee & Bruno's work (see p. 96 in de Clercq et al., 2006). Article TWO relates to the entrepreneur-VCs negotiation process and the investment decision. I argue, however, in that article that an entrepreneur's VC selection may have various ramifications for the actual relationship as well. Therefore, Article TWO relates to some extent to the post-investment phase as well. Article THREE concentrates on the relationship between investors and entrepreneurs, when the formal relationship has been formed. The main emphasis in Article THREE is on the relative power of the parties in the relationship. Article FOUR relates to the early stages of the VC process. Both Article TWO and Article FOUR relate, to some extent, to the time period when the formal relationship begins. In Article FOUR Lahti and I study how an advisor's may influence an entrepreneur's process of acquiring VC funding. Article FIVE concentrates on only a fairly short period of the relationship. The main emphasis of the last Article is on the publicity that VC-backed entrepreneurs receive for a maximum of 720 days prior to and after VC investment. The

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48 Alternative VC cycle presentations have been presented at least by Ruhnka & Young (1987) and Giudici & Paleari (2000). In addition, in Article ONE we present our suggestion of the process between investors and entrepreneurs.
illustration of the articles alongside the VC cycle is presented in figure 11. I used same picture in the beginning of the thesis.

![VC Cycle and positioning of Articles](image_url)

Figure 11 VC Cycle and positioning of the Articles accordingly.

### 6.2. Positioning of the Articles according to research fronts and previous articles

Cornelius and Persson (2006) conducted a bibliometric analysis where they analysed who is who in venture capital research and according to their analysis VC research can be divided into either management or finance oriented research fronts. Scholars such as Lerner, Gomper, Akerlof and Amit represent the finance oriented approach, while Sapienza, Fried, MacMillan and Wright represent a more management oriented approach. Table lists the most cited authors from Cornelius and Persson’s (2006) article. All those authors have been cited more than 20 times, before 2006, according to the Social Sciences Citation Index – Web of Science, in papers under the search word phrase “venture capital”. Columns A1, A2, A3, A4 and A5 list the number of times these authors are cited in my articles (A1= Article ONE, etc.). All ten of the most cited authors in my Articles are either management scholars or both management and finance scholars (numbers 1. and 3. after the names of the authors) based on Cornelius and Persson’s categorisation. Only three authors out of 20 mostly cited (authors from Sapienza to Hellman) in my Articles are ranked by Cornelius and Persson as mainly finance oriented (Megginson, Mason and Barry). In terms of citations this means that

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49 The classification was executed by classifying journals into finance and economics journals and management journals.
only 14 citations out of 210 citations are from purely finance oriented scholars’ publications.

In sum, it can be said that my approach represents more of a management approach than a finance approach for venture capital research. Bibliometric analysis, as with all methods of analysis, is not free from criticism and this should be acknowledged. It has been criticised, for example, that all citations are treated as equal, although the rationale of a citation can vary considerably (Cronin, 1984). In addition, it takes a very long time to get an article published and some authors may not be included because their work was not available to other authors (Nerur et al., 2008). For example, I quote De Clercq and Manigart fairly extensively in my articles but these authors are not shown in Cornelius and Perssons’ analysis, due to the research period (prior to 2006). However, this analysis still illustrates fairly well how my thesis is positioned heavily towards the managerial approach.

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<th>A1</th>
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</table>

1) Mainly cited in management journals, 2) mainly cited in finance journals, 3) cited in both academic and finance journals, 4) not applicable (Cornelius and Perssons do not report the status of these authors)

Table 9  Comparison of extensively cited authors’ and my Articles’ citations.
6.3. Positioning of the Articles according to research strategies

In order to categorise my research projects according to different research strategies I will utilise Saunders et al.’s (2009) “research onion”. Research strategies are considered by authors to be the third layer of the onion. A more complete presentation of the research onion is included in Appendix 2. According to Saunders’ et al. the following research strategies exist: experiment, survey, case study, action research, grounded theory, ethnography and archival research. Below, I will briefly discuss the strategies that I have utilised in my articles. A summary of the categorisation is presented in table 10.
<table>
<thead>
<tr>
<th>Research Strategy</th>
<th>Explanation *)</th>
<th>Answers</th>
<th>Linkage to thesis</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Survey</strong></td>
<td>Research strategy that involves the structured collection of data from a sizeable population. Although the term “survey” is often used to describe the collection of data using questionnaires, it includes other techniques such as structures, observation and structured interviews.</td>
<td>Who, what, where, how much and how many</td>
<td>Survey strategy has been utilised in Article FIVE. 439 CEOs or management team members were contacted in Finland and 104 replies were received.</td>
</tr>
<tr>
<td><strong>Case study</strong></td>
<td>Research strategy that involves the empirical investigation of a particular contemporary phenomenon within its real-life context, using multiple sources of evidence.</td>
<td>Why, what and how</td>
<td>Case study approach has been utilised in two articles. In Article TWO four case companies were selected and interviewed. In addition the focus group interview method was utilised. Four advisors, three entrepreneurs and four VCs were interviewed for Article FOUR. Additional research material was utilised.</td>
</tr>
<tr>
<td><strong>Ethnography</strong></td>
<td>Research strategy that focuses upon describing and interpreting the social world through first-hand field study.</td>
<td>n/a</td>
<td>Ethnography and participant observation research strategy was utilised for Article Three. Altogether the data consist of an eighteen month observation period with one entrepreneurial firm.</td>
</tr>
<tr>
<td><strong>Archival research</strong></td>
<td>Research strategy that analyses administrative records and documents as principal sources of data because they are products of day-to-day activities.</td>
<td>n/a</td>
<td>An archival research strategy (with a combination of survey strategy) has been utilised in Article FIVE. VCs' portfolio firms’ publicity (in terms of newspaper articles) has been analysed before and after VC investment.</td>
</tr>
</tbody>
</table>

*) Explanations derived from Saunders et al. 2009

Table 10  Research strategies and linkage to the thesis.
6.3.1. Survey

As the name indicates, a survey strategy implies procedures where data are collected from a certain population using e.g. questionnaires, interviews, web surveys or email surveys. Depending on how the sampling is organised it might be possible to draw conclusions that are representative for the entire population by researching a small sample of the entire population. I have used survey research strategy in one of my articles. In Article FIVE I collected additional data to further analyse the hypothesis. A total of 439 CEOs or management team members from Finnish entrepreneurial ventures were contacted by email and altogether 104 replies were received.

6.3.2. Case study

Case study research strategy commonly involves a combination of various sources of information that is organised in a meaningful way to provide answers for a researcher. The case study approach is especially meaningful when a researcher is interested in gaining a deep understanding of the research area and it might be difficult to come up with a research hypothesis without a deeper understanding of the phenomenon. In case studies various data sources are used simultaneously. For example, interview data are verified with some additional data such as press releases or financial statement data. I have utilised the case study research approach in two of my Articles. Methodologically I followed Eisenhardt’s (1989) case study protocol.

In Article TWO I interviewed four entrepreneurs at least once and contacted them afterwards to clarify some details. In addition, three out of four entrepreneurs participated in a focus group interview where the research topic was discussed in a group situation. In addition, I utilised various additional data sources such as company reports, newspaper articles and press releases to fully understand the phenomenon. In Article FOUR the case study approach was also utilised. The first version of the article that was presented at the ISBE conference in Cardiff 2007 contained data from five case studies (i.e. five advisory firms were analysed and their representative was interviewed at least once). In the review process, additional data were requested. We conducted three additional interviews with entrepreneurs that had utilised advisory services and four with VCs.

6.3.3. Ethnography

In ethnography the purpose is to describe and explain the phenomenon under research according to how the researcher sees it. Commonly ethnographical studies can last for a long time and involve observation periods. They are not common in the entrepreneurial and especially the entrepreneurial finance literature. The research approach could potentially, even though it is time consuming and difficult to execute, provide much insight and new information. It might be also difficult to find a research setting that is willing to let a researcher participate and observe the research subjects. I utilised the ethnography and participant observation research strategy in Article THREE. I was interacting and acting as an investor with one entrepreneurial firm for a period of eighteen months. During this period of time I was able to provide new insights especially related to power between entrepreneurs and investors and how power can transfer in that relationship.
6.3.4. Archival research

In archival research strategy the principal source of data consists of administrative records and documents. The data have originally been developed for some other purpose and will be utilised in research purposes later. Due to the nature of the data, they do not necessarily contain all relevant information that is needed to answer the research question at hand or otherwise provide meaningful results. Therefore, some additional methods and data sources may sometimes be used with archival research. In Article FIVE, I utilised Finnish newspapers’ online news article databases and analysed the publicity given to VCs’ portfolio firms before and after VC investment. In addition to that, I utilised survey strategy to fully understand the logic and behaviour of the portfolio firms in terms of seeking publicity.

6.4. General positioning of the thesis

After the thesis has been positioned among the venture capital cycle, previous articles (i.e. a financial or management oriented approach) and according to research strategies, the main conclusion is that it is difficult to indisputably categorise the thesis. First, there are various ways to categorise a thesis. Second, the thesis consists of five Articles with different methods, data and approaches. Therefore, a very clear categorisation is difficult. However, by using these various “positioning methods” it is possible to say that the thesis concentrates on the investor-entrepreneur relationship during different phases of the VC cycle. It represents a much more management oriented approach than a finance oriented approach. It utilises various research strategies: such as survey, case study, ethnography and archival research. In addition, different research choices such as multi-method and mixed methods are utilised. Finally, the time horizon of the articles varies. Some are longitudinal while others are more cross-sectional.
7 CONCLUDING DISCUSSION

Going back to the original aim of the thesis: to improve the position of entrepreneurs in relation to venture capitalists and other risk financing sources (i.e. business angels and corporate venture capitalists) both before and after entrepreneurs have committed to a relationship. A lot of work – research projects, analysis, interviews, literature searches and writing – has been conducted. Five Articles have been produced and a lot of arguments and viewpoints have been presented. In table 11 I have summarised the aim of individual articles.

<table>
<thead>
<tr>
<th>Article</th>
<th>Aim of the article</th>
</tr>
</thead>
<tbody>
<tr>
<td>Article ONE: A1: An Entrepreneur's Guide to the Venture Capital Galaxy</td>
<td>To summarise what we know about venture capital, business angel and corporate venture capital funding. A literature review article.</td>
</tr>
<tr>
<td>Article THREE: Power between Entrepreneurs and Investors: A Case Study. The Journal of Entrepreneurial Finance and Business Ventures. Vol. 11 issue 1. p. 51-77</td>
<td>To utilise power constructs (dependency, power balance/imbalance, power sources) and analyse their applicability in investor-entrepreneur relationships</td>
</tr>
<tr>
<td>Article FOUR: The Role of Advisors in the Venture Capital Investment Process</td>
<td>To study the role of advisors in the venture capital investment process and analyse their effect on research theory and practice.</td>
</tr>
<tr>
<td>Article FIVE: Certification Effect of Venture Capitalist</td>
<td>To study professional venture capitalists’ certification of early stage ventures.</td>
</tr>
</tbody>
</table>

Table 11 Aim of individual articles.

Before I go into the general results and contributions of the thesis, I will start by discussing limitations, validity, reliability and objectivity. After that I present the theoretical contributions and some future research suggestions and finally I conclude by discussing the practical implications of the thesis.

7.1 Limitations

First, I would like to point out the similarities and differences between various venture capital funding providers (i.e. business angels, professional venture capital and corporate venture capital). A presentation of the different characteristics of the funding providers has been presented in Article ONE. From the point of view of entrepreneurs it is, I believe, essential to understand these differences and to acknowledge what would
be the optimal investor candidate for any specific situation. For that reason, I have covered all three primary funding sources in my thesis. When I have referred to academic articles and presented my propositions and suggestions it is important to acknowledge whether the data and viewpoints refer to the academic finance literature in general (meaning that propositions can be generalised to all three sources of equity funding), or whether they are only applicable perhaps to one or two sources of funding. In my thesis this risk is perhaps greater due to the reason that I have both utilised various data sources and literature that covers either all or some of the funding sources (i.e. VCs, BAs and CVCs). Therefore, it requires special attention to ensure which viewpoint is represented in a certain situation in the thesis.

The second limitation or concern relates to how closely the articles are related to each other. I have tried to identify research gaps and offer fresh ideas to help us to further understand aspects that are important in the investor-entrepreneur relationship. In addition, all articles relate to the investor-entrepreneur relationship, although their viewpoints, theoretical lenses and data are quite commingled. In addition, I have provided a lot of argumentation and reasoning as to how the various articles relate to each other in chapter 6.1., for example, from the venture capital cycle’s point of view. Finally, due to the approach to analysing the investor-entrepreneur relationship I have been able to discover various very interesting issues and actors. For example, the identification of advisors in the VC-entrepreneur process can have substantial consequences for VC practice and academic research on entrepreneurial finance and venture capital.

The third, limitation or at least a consideration point is that I have only utilised Finnish data but most of the references are international. This is mainly due to the reason that there are so few domestic articles and reference sources that can be utilised. However, this issue is a concern that should be taken into account when this thesis is evaluated.

Fourth, the data were mostly collected (especially concerning Article TWO) during the IT-hype and dot.com boom. This was quite a unique period of time especially for growth oriented ventures that are capable of acquiring VC funding. Therefore, some of the findings might be different if I would replicate the study, for example, now when the world is slowly recovering from a global financial crisis.

Fifth, my thesis is heavily based on case study data. Normally generalisations based on case study data are not possible. However, the Finnish venture capital market is very small and it is difficult to conduct empirical studies with large databases. Furthermore, a small market has its benefits as well. For example, in Article FOUR, where we collected data by conducting interviews, we were able to a cover a majority of the advisory firms that operate in Finland. This is due to the reason that the market is so small and there are so few actors. Another aspect regarding case study approach relates to depth of the data. Particularly in Article THREE, I interacted with and followed an entrepreneurial team for a period of eighteen months. So, even though Article THREE was based on only one case, it was very carefully analysed. In that particular research area – power relationships between investors and entrepreneurs – it was essential in order to get in depth data on the relationship.

Finally, regarding Article FIVE were I study the media attention of VCs’ portfolio firms today I would definitely include some high profile blogs that may have a somewhat different editorial policy than traditional financial newspapers (from the U.S. TechCrunch, Mashable and VentureBeat, in Finland ArcticStartup and...
Vierityspalkki\textsuperscript{50}). These outlets constantly search and are willing to write about very early stage entrepreneurial firms. Hence, the media attention that VCs' portfolio firms could get both prior to and after VC funding might have been somewhat different if these new media outlets could have been included in the analysis. In addition, regarding the certification effect of investors, a relevant question to ask is how well is the general public able to comprehend the challenges that acquiring VC funding actually makes of entrepreneurs? If relevant parties such as employees, business partners or customers do not understand this, they do not consider VC investment as a certifying event either. Also interviews among journalists may have provided some additional information on why they have selected or mentioned a particular portfolio firm in their article. However, these kinds of interviews were not conducted in Article FIVE. Below in chapter 7.2.4, the Reliability and validity of Article FIVE, I also discuss the operationalisation of certification.

In sum, regarding limitations, it is clear that there are some limitations that should be taken into account when the thesis is evaluated. However, taking into account the challenges and complexity of the research arena the limitations can be considered to be rather minor.

### 7.2. Validity and reliability of the thesis

Validity and reliability can and should be always debated, especially when case study research is in question. Validity concentrates on the issue of whether the findings really are what they appear to be. Reliability, in turn, refers to whether data collection and/or analysis will provide consistent results. Below I will first introduce four main tests that are commonly utilised to test the quality of the social research according to Yin (2003).

### Table 12  Tests to ensure validity and reliability.  

Due to my research approach of having five different Articles where four of them contain data, I have divided the discussion into four sub-chapters covering the relevant Articles (TWO, THREE, FOUR and FIVE) related to reliability and validity. Article ONE, which does not contain data has been excluded from this discussion.

Eisenhardt (1989) has been the key source and reference point that I have utilised to ensure the validity and reliability of the Articles that are case studies or contain qualitative data (Articles TWO, THREE and FOUR). Regarding Article FIVE, where I have used empirical data collection and statistical methods to analyse the media.

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<table>
<thead>
<tr>
<th>Test</th>
<th>Summary of the test</th>
<th>Case study tactic</th>
<th>Phase of research in which tactic is used</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construct validity</td>
<td>Establishing correct operational measures for the concepts studied</td>
<td>Use multiple sources of evidence</td>
<td>Data collection</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Establish a chain of evidence</td>
<td>Data collection</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Have key informants review draft case study report</td>
<td>Composition</td>
</tr>
<tr>
<td>Internal validity</td>
<td>(for explanatory or causal studies only, and not for descriptive or exploratory studies): establishing a causal relationship, whereby certain conditions are shown to lead to other conditions, as distinguished from spurious relationships.</td>
<td>Do pattern-matching</td>
<td>Data analysis</td>
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<tr>
<td></td>
<td></td>
<td>Do explanation building</td>
<td>Data analysis</td>
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<tr>
<td></td>
<td></td>
<td>Address rival explanations</td>
<td>Data analysis</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Use logic models</td>
<td>Data analysis</td>
</tr>
<tr>
<td>External validity</td>
<td>establishing the domain in which a study's findings can be generalised</td>
<td>Use theory in single-case studies</td>
<td>Data collection</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Use replication logic in multiple-case studies</td>
<td>Data collection</td>
</tr>
<tr>
<td>Reliability</td>
<td>demonstrating that the operations of a study – such as the data collection procedures – can be repeated, with the same results</td>
<td>Use case study protocol</td>
<td>Data collection</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Develop case study database</td>
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</table>
attention of VCs’ portfolio firms, the key concern is the operationalisation of certification as media attention. It is not a perfect measure but sheds some light on the VCs’ certification of their portfolio firms.

7.2.1. Reliability and validity of Article TWO

In Article TWO I have utilised various methods to ensure the validity of the Article. First I used various data sources (one-to-one interviews, focus group interviews, secondary data) and all key informants also reviewed my analysis. In addition, I conducted a focus group interview where three out of four case company key informants got together to discuss the key propositions and suggestions that I had developed in the preceding one-to-one interview sessions. All these methods are likely to increase the validity of the article. However, as in case study research in general it is good to acknowledge that the article’s suggestions and propositions are only based on four case studies. Regarding reliability and the issue of whether the same study could be replicated and if it would lead to similar results is another important aspect when the quality of a research is evaluated. I followed Eisenhardt’s (1989) case study protocol and used triangulation that should further increase the reliability of the results. However, as pointed out in the limitations chapter of the thesis, the data and interviews concentrated on quite a unique time period in the venture capital investing business (dot.com era). Therefore, the time period may have influenced the results and new interviews conducted as the world is recovering from a financial crisis may lead to somewhat different propositions.

7.2.2. Reliability and validity of Article THREE

In Article THREE, I also utilised Eisenhardt’s (1989) case study protocol. The key methods to ensure validity were the conducting of multiple interviews, an analysis of different data sources, pattern matching and the presentation of rival explanations. The generalisability of the results (i.e. external validity) was conducted with the help of the existing literature and an analytical generalisation. One key concern of this article was my active involvement in the process as an investor. In other words, the construct validity was a major issue. The key used methods to increase construct validity were the extensive utilisation of various data sources, I interviewed key informants and they reviewed the report afterwards, and the establishment of a detailed chain of evidence between analysis, propositions and data. The reliability was increased by using the case study process framework promoted by Eisenhardt (1989). In table I of the article (see page 59 of the article) I have summed the key methods that I have utilised to increase validity and reliability.

7.2.3. Reliability and validity of Article FOUR

In Article FOUR various actors of VC investment process were interviewed. Altogether five advisory firms, three entrepreneurs that had utilised advisory firms and four VC firms were interviewed in the study. The key research interest of “the role of advisors in the venture capital investment process” was analysed in detail. In addition, the most valuable source of information, the advisory firms, were able to review and comment on the draft of the article beforehand, which should increase its validity. The most important method to ensure the reliability of the study was to follow Eisenhardt’s (1989) case study protocol. The key phases of the process were constructing three
propositions: The advisors have the expertise to i) locate and approach investors, ii)
prepare entrepreneurs to discuss with investors and iii) increase the valuation and
improve terms of the transaction. Research questions based on the literature, the pilot
interview of the case study protocol, various interviews, the semi-structured interview
format, secondary data collection, the transcription of the interviews using the “24 hour
rule”, and finally data and results were compared to the existing VC literature. The case
study protocol is presented in detail as an appendix of Article FOUR (see pages 253-254
of the article).

7.2.4. Reliability and validity of Article FIVE

While I was developing and presenting the general idea of Article FIVE I received a lot
of feedback regarding the operationalising of certification as media attention. I argue
that a VC’s investment decision increases the credibility of the firm and that leads to
increased media attention. However, my logic is not free from criticism. First, it could
be that journalists are more interested in the firm for some another reason. For
example, it is natural that after a VC investment the venture enters into a new
development phase and starts to commercialise its products. This new phase in the
venture’s development cycle actually leads to increased media attention not the VCs’
investment and increased credibility. Another explanation could be that it is the VCs’
investment event that interests media not the venture as such (whose credibility has
increased). A third explanation could be that VCs actually encourage their portfolio
firms to be more active and inform the media constantly. This kind of proactive
behaviour towards the media could be something that entrepreneurs have not done
before.

I have analysed all these three alternative explanations in order to ensure the validity of
Article FIVE. First of all, one could say that it is a “given fact” that acquiring VC funding
is very challenging and only a small number of firms succeed. This should implicitly
suggest that VCs certify their portfolio firms. However, to ensure that this really is the
case I have conducted various tests to further analyse the phenomenon. First, I asked
CEOs and other key informants of VCs’ portfolio firms to name one of their key peer
companies at the time of the VC investment. Based on this analysis (see figure 1 and
table II of Article FIVE) the VC backed venture’s media attention increased faster than
that of the peer companies and the difference is statistically significant. Second, I
conducted a content analysis among the articles and based on the analysis in only 79
out of 334 media hits the VC was actually mentioned. These analyses provide strong
evidence that VC investment increases general media attention. Third, I tested whether
it could be that VCs are more demanding of active PR and encourage or demand
portfolio firms to be more active in their media activities, which should lead to
increased media attention. According to my analysis and survey data only three out 31
respondents had received such a suggestion from VCs. Therefore, VCs encouragement
does not explain the increased media attention either. Regarding the reliability of
Article FIVE there is much less criticism and concern. Data collection was conducted in
a consistent and well documented manner and secondary databases were used in the
process. In sum, the operationalisation of certification as increased media attention is
not free from criticism and raises some concerns. However, for young companies that
lack credibility and impressive track records the certification provided by VCs may
potentially have many positive aspects and the phenomenon deserves attention.
7.3. Objectivity

As often stated it is nearly impossible to conduct a 100% objective research. However, in this thesis the issue of objectivity may have a somewhat larger meaning. One of the reasons why I started this research process was my aspiration to understand and perhaps support entrepreneurs in their relationships with investors. When this is the starting point how can anybody be 100% objective? And further, my former position as an entrepreneur could have shaped my thinking more positively towards being sympathetic to entrepreneurs (see Pronin et al., 2004 about biases in objectivity). Another interesting fact is that, while working on my thesis, my viewpoint has changed constantly. First, I started as a pure researcher on entrepreneurial history. Next, I conducted an investment (see Article THREE) in an entrepreneurial venture (see Lehtonen, 2008). During 2007 I co-founded a venture, which raised a few million euros for our venture (i.e. I became an entrepreneur that negotiated and interacted with investors). We also utilised advisors while we acquired funding (Article FOUR). Then in 2008 I co-founded an early stage investment fund and venture accelerator52. At the time of writing this introduction to my thesis (2010) I am working as a partner and investor in another early stage venture accelerator and investor. I constantly interact with investors and entrepreneurs. In sum, I have an extensive practical experience and viewpoints on the investor-entrepreneur relationship. I personally consider it an advantage that helps me thoroughly understand the research area.

Keeping in mind the original aim of the thesis, it, could be argued that a researcher has more insights and tacit knowledge, because they possess extensive additional information, which should help to conduct a more detailed and higher quality piece of research. Thus, for this thesis, I have utilised my extensive practical information and combined it with previous theoretical debates and the academic entrepreneurial finance literature. The end-product is a thesis that contains five Articles that offer interesting and relevant viewpoints that could help entrepreneurs improve their position in relation to investors.

7.4. Theoretical contributions and suggestions for future research

Regarding the theoretical contribution of the thesis, key discoveries relate to the identification of advisors, the role of power in the relationship, adopting new viewpoints on the selection process of the investors and entrepreneurs and the promotion of the certification effect in the very early stages of ventures. Below I will discuss these contributions in more detail and provide suggestions for further research.

One very interesting and relevant aspect both from a practical point of view and a theoretical point of view is the inclusion of advisors in the dyadic relationship between entrepreneurs and investors. We consider advisors to be such an important research avenue that we are currently conducting additional research in this setting (Lahti & Lehtonen, 2009). The identification and analysis of the role of advisors is one of the key theoretical contributions of my thesis. Advisors can be seen as a signal of quality (agency theory and signalling theory), advisors provide needed resources and eliminate the “knowledge gap” between entrepreneurs and investors (resource based view). In addition advisors may provide support that will increase the likelihood that the post-investment is based on trust and positivism (procedural justice theory). In addition to

52 The purpose of an accelerator is to speed up a venture’s development, go-to-market process, help acquire funding and provide support that should help the venture grow rapidly.
our analysis and description of advisors there are a lot of very interesting future research avenues related to advisors. Key questions that should be studied in more detail are: How do entrepreneurs find and select advisors, what kind of advisors do entrepreneurs utilise, which advisors provide the most value, what are the differences between advisors (government backed vs. private for example), how do advisors influence the relationship during the post-investment phase? We have touched upon these aspects in our case study article but rigorous empirical analysis is highly recommended, as is replication in other large markets such as in the U.K. and U.S.

Another relevant and also potentially very relevant theoretical contribution is the utilisation of general power taxonomy in the investor-entrepreneur relationship. Power constructs have been surprisingly little utilised in this context. However, based on my participant observation data it seems that power constructs can provide valuable insights that help us understand the investor-entrepreneur relationship after it has been formed. They, for example, help us to understand what the key power sources are that the parties can utilise, how power fluctuates between parties, and what is proper balance of power is. Several studies have acknowledged the fact that the operating environment is very turbulent (Sapienza & De Clercq, 2000) and it is likely that disputes will arise (Higashide & Birley, 2002). In addition, the amount of investors’ value added is still an area of debate (Busenitz et al., 2004). Therefore, power constructs may provide additional insights that could help us understand, explain and even form more suitable investor-entrepreneur dyads. In addition, power constructs could provide insights on how day-to-day co-operation between investors and entrepreneurs can be organised more effectively. Effective post-investment phase co-operation and activities are the key components of value creation and indicate successful exits. Hence, if power constructs could help us to promote co-operation it is definitely a step forward and would probably also mean higher valuation exits. In future I expect power constructs to be taken into account more often when entrepreneurs’ and investors’ relationships are studied. Key questions might analyse, what is a good balance of power between parties and is it dependent on characteristics such as entrepreneurs’ experience and stage of venture? In addition, it would be interesting to compare whether VCs, CVCs and BAs power sources and their utilisation of power differs and to discover the underlying reasons if there are differences. Ultimately, it would be very interesting to analyse the linkage between the power aspects and whether an exits is successful/unsuccessful.

In Article TWO I have promoted the idea of turning the prevailing “how investors choose portfolio firms thinking” upside down. This idea is not entirely new but is surprisingly sparsely discussed in the entrepreneurial finance literature. I present, in the article entrepreneur’s selection and decision process model (see Article TWO, figure 1), the idea of an entrepreneur’s quality, experience level and required nonfinancial benefits. In addition, I presented in Article TWO a “check list” of various value added elements that investors could provide for entrepreneurs. The check list is based on Sapienza et al.’s (1996) work. It would be interesting to study how beneficial this kind of checklist would be for entrepreneurs in practice and what would be the most crucial elements of the checklist. For example Hellman and Puri (2000) have suggested that VC funding has a different function for different kinds of ventures. I fully agree with that but I think that it would be beneficial to develop Hellman and Puri’s idea even further to analyse the best possible investor-entrepreneur matches. The ultimate goal should be to develop high quality ventures that provide positive consequences for entrepreneurs, investors and the entire economy. A “Check-list” approach could better support entrepreneur-investor dyads.
As I have argued earlier, the significance of certification has not been fully understood and analysed in the investor-entrepreneur context. A lack of valid research measures has probably led to a situation where certification has not been studied in very early stage firms – where its benefits would be greatest. An illustrative and concrete example among many start-up entrepreneurs and investors goes as follows: Currently there are probably hundreds of former Nokia employees in Finland who are planning to start their own ventures. Due to their earlier experiences of working in a big corporation, their thinking is probably the unrealistic notion that they will be taken seriously by everybody and that they will get a chance of presenting their proposal. In the start-up world, however, you continuously “fight” to get companies and larger business partners to take you seriously. Therefore, all means that could increase a start-up’s credibility are usually welcome. Therefore, considering the “credibility gap” that start-up entrepreneurs face, it is very relevant that I have advanced and promoted the idea of investor certification to cover early stage firms as well. Regarding further research avenues, I believe that it would be very interesting to measure how big an impact VCs participation could provide for portfolio firms. For example, focus group interviews could shed light on this area. In addition, a more general analysis of how early stage firms could increase their credibility might provide valuable insights for entrepreneurs.

It can be said that entrepreneurial finance research has grown dramatically in recent years and more specific research topics are starting to attract interest from researchers. In addition, new phenomena are emerging in the VC business. For example, crowdsourcing has emerged in VC investing as well. In Grow VC service (www.growvc.com) investors, experts and entrepreneurs can network, share opinions and even conduct investments online. In Venture Bonsai (www.venturbonsai.com) a big group of investors can join together to make very small investments in entrepreneurial firms. Then there are companies such as Y Combinator in the U.S. that have developed a business model that is somewhere between incubators and very early stage investing. Y Combinator invests a small amount of capital (average 18,000 USD) and supports firms for a period of three months and helps entrepreneurs develop their business idea. Afterwards, portfolio firms have the possibility to pitch their businesses to later stage investors. Y Combinator acts in this model as a certifying agent for early stage firms. It remains to be seen whether these new initiatives will actually start to attract attention that then has larger implications. If so, they might also form relevant research areas for VC research. It is in everybody’s interest to form effective entrepreneur-investor dyads that create value for all stakeholders and that entrepreneurial teams get support in the early stage of their development.

### 7.5. Practical implications

As stated earlier, I have taken a fairly practical approach to my thesis. The guideline that I have followed is that my articles should provide practical relevance and insights for relevant stakeholders. This has been conducted in theoretically solid manner. The main focus area has been on how entrepreneurs can improve their position of power in relation to investors both prior to the relationship being formed and after that. I have utilised various theoretical lenses, approaches, methods and data in order to

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53 According to Wikipedia (retrieved from Wikipedia 15.3.2010) Crowdsourcing is a neologistic compound of Crowd and Outsourcing for the act of taking tasks traditionally performed by an employee or contractor, and outsourcing them to a group of people or community, through an "open call" to a large group of people (a crowd) asking for contributions.

54 www.ycombinator.com, information retrieved from company’s website 2nd of April 2011.
understand the phenomenon better. Below I will discuss the practical implications of my research project for various key stakeholders.

7.5.1. Implications for entrepreneurs

If I had to offer only one very short suggestion for entrepreneurs based on my thesis, it would be utilise advisors when you negotiate with investors. In the best case scenario they are able to provide major benefits for entrepreneurs. They could for example improve valuation, shorten the time that the process requires and eliminate some harsh contract covenants. In Finland, new advisory firms have emerged in recent years and, therefore, there are quite a lot of choices for entrepreneurs to choose from. In addition, local government and some associations provide advisory services for entrepreneurs as well. Since the entrepreneurs’ choices have grown, entrepreneurs’ must be more selective and ensure that they get the best possible advice for their specific needs. Also the terms on which advisors operate vary, with their key components being retainer, success fee and ownership (i.e. sweat equity).

Second, investors can potentially but not always, provide substantial value added for their portfolio firms (De Clercq et al., 2006). However, the key is how entrepreneurs are able to ensure, or at least improve the possibility that an investor and an entrepreneur form a good match. The key aspects for entrepreneurs to analyse and evaluate are its own needs and requirements and the potential value added that investors are able to provide. This issue is extensively covered in Article TWO. The Article offers tools (a decision tree and check list of potential resources) how entrepreneurs could evaluate and analyse it beforehand whether the investor could provide needed nonfinancial value added for entrepreneurs.

Third, interestingly while interviewing advisors for Article FOUR two advisors independently reported that when they explain to entrepreneurs what it means to become an investors’ portfolio firm (mainly meaning VCs’) many entrepreneurs actually changed their view about acquiring VC funding. Entrepreneurs found it too demanding and restrictive to work with investors and they wanted to maintain their independence. In addition, because it is very difficult to get rid of investors once they have invested in a venture, it is important for entrepreneurs to analyse the consequences of working with VCs beforehand. Sometimes there is no alternative other than to acquire VC funding, but sometimes less ambitious growth targets, bootstrapping, government grants or some other methods could be good alternatives for entrepreneurs and better than VC funding. Therefore, one implication of the thesis is that it promotes the idea that entrepreneurs should think about i) how badly they actually want to acquire VC funding and/or ii) is there an alternative that would be a better option in their individual situation?

Fourth, I think that the importance of outside certification may not have attracted as much attention as it should in the entrepreneurial finance context. Even though my thesis has not measured the implications of certification (for example in terms of increased sales, credibility etc.) for entrepreneurial ventures, I recommend that entrepreneurs should emphasise and communicate more broadly when they are successful in acquiring VC funding. That is a signal of quality for all stakeholders.

55 After the articles that form my thesis we have done further research on advisors and it seems that professional advisors are much better at providing value for entrepreneurs than, for example, government civil servants (Lahti & Lehtonen, 2009).
Credibility and particularly lack of credibility is a key concern for start-up ventures, therefore entrepreneurs could utilise VC investment as a certification event.

Fifth (based on Article ONE), different investors may have very different approaches, agendas, motivations and operating procedures. Consequently, entrepreneurs should understand this and approach suitable investors for their individual needs.

Sixth, in practice, managing and running a start-up venture with or without investors involved is commonly a turbulent position. If you add (power) conflicts between investors and entrepreneurs into the equation, the situation may become extremely challenging for entrepreneurs. According to Article THREE power between parties is not static or evenly distributed between entrepreneurs and investors. Therefore, an entrepreneur that has not managed to get a very good shareholder and investment agreement (meaning that investors have gained a lot of legal power) may potentially gain more power by utilising other power sources (i.e. coercive, reward, expert and referent power). This could mitigate the risk of the power conflict and help entrepreneurs run the business independently.

7.5.2. Implications for investors

This thesis concentrated primarily on entrepreneurs’ point of view but it provided also some implications for investors as well.

Image benefits (i.e. certification) could be approached from investors’ point of view as well. Business angels, often corporate venture capitalists and especially venture capitalists may provide substantial image benefits for their portfolio firms. However, based on my data investors (venture capitalists) do not actively communicate this value added for their potential investment candidates. Other value added components such as access to networks, strategy consulting and the possibility to obtain additional funding are much more extensively communicated by the investors (Ehrlich et al., 1994; Rosenstein et al., 1993). However, at the same time these other value added components are much more case sensitive and controversial than certification (see e.g. Busenitz et al. (2004) p. 789 for discussion on VCs’ value added). Therefore, one practical implication of my thesis is that investors should emphasise more effectively the importance of certification to their portfolio firms. This may even help investors to get more favourable investment terms from entrepreneurs.

Second, it might be that the power aspects that were discussed in Article THREE could provide unexpected consequences for investors. Referring to the old saying that “If you owe the bank $100 that’s your problem. If you owe the bank $100 million, that’s the bank’s problem.”56 This saying could very well be the other way around in entrepreneurial finance: When an investor invests in a very early stage firm where, for example, the entrepreneur works hard to get the business up and running, maintains most of the key contacts personally and has the best knowledge of how to utilise the developed technology it might be very difficult or even impossible to find anybody to replace the entrepreneur. There are only very few people who would be capable, willing to stand the same kind of pressures and willing to work with no salary or with a very small salary in order to get the business up and running. Therefore, even though the VC literature suggests that investors commonly have more power in the relationship, in very early stage firms this might be the other way around. This is something that

investors, especially very early stage business angels, should take into account. Finnish government backed business angel network has, for example, drafted a common shareholder’s agreement that should provide protection for business angels. However, if a business angel is not able to find a substitute for the entrepreneur, who would be willing to replace entrepreneur, then the contract is less applicable for investors and the investors’ risks are likely to increase.

7.5.3. **Implications for advisors**

As it was identified in Article FOUR, advisors provide substantial benefits for entrepreneurs but their existence is not well known, even among entrepreneurs that acquire VC funding\(^\text{57}\). Therefore, advisors could get more clients by actively marketing themselves among entrepreneurs and other stakeholders that interact with entrepreneurs (see table 1 on page 235 of the Article: none of the advisory firms conducted any active marketing). Since the majority of an advisor’s return comes from success fees, it is essential for advisors to select the best possible cases that have realistic chances of acquiring funding. A larger potential client base would at least somewhat help advisors to get more promising clients.

Second, the Finnish Government is concerned that Finnish start-ups are not able to acquire enough private funding. The government provides funding in terms of e.g. grants, subsidised loans and equity investments for early stage firms, but when these funding sources are utilised there is a danger that the firms are not able to acquire follow-on (private) capital. There are at least two explanations for this problem: The first viewpoint suggest that there is simply not enough funding available for potential growth oriented firms and the lack of funding explains the small number of growth oriented firms (e.g. equity gap) (Mason & Harrison, 1992) According to this viewpoint, venture capitalists and even business angels are more interested in funding more mature firms that have at least some kind of a track record. In addition, growth oriented firms do not get funding and, hence, they do not have the possibility to become high growth firms. However, if you discuss with investors, at least in Finland, they do not support this view. They seem to suggest that the main reason for the small number of growth oriented firms is that there are not enough high quality investment candidates, regardless of the development stage of the firms. In other words and according to this second viewpoint, supply (of risk capital) and demand (of investment candidates) do not meet each other on the market and the investment readiness of ventures is low (Mason & Harrison, 2001). In other words, entrepreneurs do not understand what is needed from them to get funding and develop their business proposal, idea, service or innovation according to the needs and wishes of the investors. If investment readiness explanation is more applicable in the Finnish market, then advisory firms could potentially improve the investment readiness of entrepreneurial firms significantly and help them to obtain additional capital. This should, in turn, also have implications for the Finnish economy. Advisors could improve the possibilities of entrepreneurial firms to acquire additional capital. My recommendation is that advisors should communicate their benefits more broadly to government organisations and potential early stage ventures. However, advisors cannot work miracles. For example, an entrepreneur’s former experience has been demonstrated to be a very critical decision factor for investors because VCs and advisors cannot increase an entrepreneur’s experience (MacMillan et al., 1985).

\(^{57}\) I do not have solid data to backup my argument. The opinion has been formed in discussions with various entrepreneurs.
7.5.4. Policy implications

It has been acknowledged that entrepreneurial high growth ventures provide a substantial amount of new job creation and are largely responsible for economic growth (Alkio, 2009). Therefore, they are very important to the Finnish economy. However, many professional venture capitalists have withdrawn from investing in early or even growth phase firms. As a result, Finnish government-backed bodies are currently investing actively in entrepreneurial ventures\textsuperscript{58}. From an entrepreneur’s perspective, this has both positive and negative implications. First, it may be challenging for entrepreneurs to learn how to apply for funding and ascertain these bodies’ decision criteria. And, to make things worse, government bodies could exclude each other. So, if you receive funding from one particular body, you may not be able to obtain any from another. In addition, the amount of funding, funding vehicles (i.e. loans, grants, guarantees or equity), funding criteria (some entities emphasise risk, others look to avoid risk etc.) and how funding can be employed varies between entities. On the other hand, from an entrepreneur’s perspective, there are so many different sources of funding that a determined entrepreneur has a good chance of acquiring finance from one outlet or another. But from the government’s point of view, it does not appear to be very efficient to maintain such a large number of different organisations. In sum, the current situation seems somewhat challenging for entrepreneurs looking to acquire funding. They might be tempted to utilise outside advisors in the process. This may lead entrepreneurs in the wrong direction, by showing them “how to apply for funding from government,” instead of asking “how will you build a scalable and sustainable business?” When entrepreneurs negotiate with private investors (i.e. BAs, VCs and CVCs), there are issues that do not directly benefit the business but which still need to be dealt with in order to acquire funding. However, the process is straightforward and largely based on evaluating the expected success of an investment candidate. In other words, investors analyse a business and if they believe that it is going to be successful, they consider investing in it.

\textsuperscript{58} Organizations such as Tekes, Vera Venture, Finnfund, Finnvera, ELY-keskus (in English: Centre for Economic Development, Transport and the Environment, respectively) and the Foundation for Finnish Inventions all actively provide funding for Finnish entrepreneurial firms. In addition, for example, Sitra, also a government backed entity, may provide funding in some situations as well. And finally local governments have their own funding and advisory organizations.
APPENDIX 1  ADVISORS IN BUSINESS LITERATURE

This information was included in the Article FOUR but was left out during review process. It is included due to a reason that it demonstrates that the phenomenon of advisors is somewhat cover in business literature earlier. Article THREE is as far as I am aware of the first academic article that is concentrated on setting.

<table>
<thead>
<tr>
<th>Name</th>
<th>Summary of book</th>
<th>How advisors have been covered in the book</th>
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<tr>
<td>Silicon Valley Edge (Stanford University Press 2000)</td>
<td>A collection of essays that speculates why Silicon Valley has become the leading entrepreneurial centre of U.S. and the entire world. The essays are divided into three parts: 1) Silicon Valley today: a view from the inside, 2) The Evolution of Silicon Valley and 3) A Clustered community. Venture Capital is heavily represented in the book and its role is highly emphasised.</td>
<td>Particularly the third part of the book relates to the role of various advisors and notes that there are six important groups among Silicon Valley’s service infrastructure: 1) venture capitalists, 2) commercial bankers, 3) lawyers, 4) accountants, 5) head hunters and 6) professional consultants. However, specialized advisors that could help entrepreneurs to acquire VC funding are overlooked. But, for example, a lawyer’s role in diminishing the time that it takes to acquire VC funding is acknowledged (p. 291). In addition, the book suggests that Silicon Valley lawyers are different (e.g. than lawyers in New York) and they do more actively provide entrepreneurs advice regarding strategic and practical matters (p. 328). Lawyers can also provide contacts and credibility (p. 331-333) These tasks are at least partially the same as what advisors (according to our terminology) could potentially do.</td>
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<tr>
<td>Raising Venture Capital (Pearce and Barnes, 2006)</td>
<td>A book that provides practical insights to entrepreneurs on how to acquire VC funding. It covers e.g. the following topics: VCs’ operating procedures, how to select VC firm, contacting VC firms, negotiating with VC firms, contracting and valuation.</td>
<td>Covers advisors and other intermediaries in less than one page (p.66-67) of this over 240-page long book. Suggests that advisors are just barely a better option for entrepreneurs than cold calling. Emphasises more risk related to advisors than benefits. The main risk identified is that it is difficult for entrepreneurs to approach VCs and recommends that they should use accountants, lawyers, investment and commercial bankers, business school professors or business people as their referrals (p.114-116). Support of advisors is disregarded. However, the</td>
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<tr>
<td>How to Raise Capital (Timmons, Spinelli, Zacharakis, 2005)</td>
<td>“American style” very practical book that offers a step-by-step plan for acquiring capital (not just venture capital but also debt financing). Also discusses e.g. the importance of team building, business planning and exiting)</td>
<td>Advisors’ role is almost entirely overlooked. For example the book acknowledges how challenging it is for entrepreneurs to approach VCs and recommends that they should use accountants, lawyers, investment and commercial bankers, business school professors or business people as their referrals (p.114-116). Support of advisors is disregarded. However, the</td>
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<tr>
<td>Book Title</td>
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<td>Venture Capital – The Definitive guide for entrepreneurs, investors and practitioners (Cardis et al. 2001)</td>
<td>As the name suggests a practical book mainly for entrepreneurs. Provides a lot of information about the venture capital industry, contacting, approaching VC etc. In addition, the book contains a lot of quotes, interviews and case studies from seasoned VCs and other industry experts.</td>
<td>Fairly positive approach towards advisors even though advisors are not consistently covered. Only mentioned here and there. E.g. agrees that sometimes advisors may review entrepreneurs’ proposition prior to approaching VCs (see Beta from our case studies above) and emphasises success fee structure (p.45). According to Brian Hughes from Arthur Andersen often their accounting firm helps to put together pitch documents for VCs (e.g. write business plans as some of my case companies). They also introduce deals to VCs among their contact network and they have a better chance of being successful (p.45-47 and p.139).</td>
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<tr>
<td>Venture Capital Funding – A practical guide to raising finance (Bloomfield, 2005)</td>
<td>Practical book for acquiring VC funding from the UK perspective. Also business angels are briefly touched upon. Provides information e.g. about VCs' operating practices and the most important contract covenants. In contrast to many other books, this book offers information about VCs' point of view as well. It may be important for entrepreneurs to understand how VCs think in order to be successful in organizing funding.</td>
<td>When discussing advisors (p. 69-70) main emphasis is on lawyers and accountants. In addition, it is warned that entrepreneurs should be careful not to hire advisors too early due to the following reasons (without explaining them in detail): 1) costs will be very high, 2) it will take more time to have advisors working with entrepreneurs than without them, 3) it will create disputes among entrepreneurs. Also discusses briefly “packagers” that could offer investment opportunities for VCs (i.e. resembles advisors that I have studied in the current paper). The benefits of these “packagers” are not extensively explained, only their problems and risks. In sum, advisors are briefly mentioned in the book but their operating procedures and benefits are overlooked.</td>
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| Venture Capital Cycle 2nd edition (Gompers and Lerner, 2004)               | Extensively quoted book about venture capital. The purpose of the book is not to offer another practical guide to venture capital investing but to enlighten the reader about possible book mentions that brokers can be used in private placement deals but without explaining what it would mean in practice for entrepreneurs (p. 124). In addition, the book presents an anonymous true story about an advisor that recommends entrepreneurs to approach the wrong kind of VC firms and, hence, causes problems for entrepreneurs (p. 154-155). | Advisors are not covered in the book. However, the negotiating and contracting between VCs and entrepreneurs are either disregarded or covered at a very high level (e.g. what are theoretical motivations for contracting) and therefore topics where
misconceptions regarding venture capital investing from academic research’s point of view. The book follows the venture capital cycle where three main themes are VC fund-raising, VC investing and exiting.

<table>
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<tr>
<th>Angel Capital: How to Raise Early-Stage Private Equity Financing (Benjamin and Marquils, 2005)</th>
<th>The book is aimed for entrepreneurs that are raising business angel funding. The book presents U.S. based strategies and guidelines that help entrepreneurs to increase changes of getting funding and evaluate how likely it is to get business angel funding.</th>
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<tr>
<td>Compared to the other books this book has the most positive approach towards advisors. Calls them financial intermediaries and determines them as follows: “Financial intermediaries are professional service providers whose sole function is to help the entrepreneur to raise money” (p. 198). The author determines the intermediaries somewhat more loosely than we do. According to Benjamin they could be finders, brokers, database managers or placement agents. The author suggests that advisors help entrepreneurs to 1) raise funding more effectively 2) give entrepreneurs more time to concentrate on running their business, 3) have existing contacts to investors, 4) have better understanding on what is the correct deal structure, terms and valuation, 5) speed up the process, 6) help put together marketing and private equity transaction documents, 7) couch entrepreneurs to present and communicate their ideas to investors (p.198-200).</td>
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APPENDIX 2 “RESEARCH ONION”

I have evaluated various different classifications and taxonomies how to map various terms and concepts in academic research. However the most useful presentation that I was able to find was “research onion” by Saunders, Lewis and Thornhill. Below is presented the main idea of concept. The layers of the presentation are the following starting from outside of the onion: Philosophies, Approaches, Strategies, Choices, Time horizons, Techniques and procedures.

Saunders et al.’s (2009) research onion
REFERENCES


ARTICLE 1

AN ENTREPRENEURS’ GUIDE TO THE VENTURE CAPITAL GALAXY

Published 2006 in the Academy of Management Perspectives, vol.20, p.90-112.

Dirk De Clercq
Vance Fried
Oskari Lehtonen
Harry Sapienza
An Entrepreneur’s Guide to the Venture Capital Galaxy

Dirk De Clercq, Vance H. Fried, Oskari Lehtonen, and Harry J. Sapienza*

Executive Overview

This article provides a foundation for an understanding of the dynamics of venture capital from the entrepreneur’s point of view. An important aspect of understanding venture capital involves the different sources of risk capital for the entrepreneur, i.e., (classic) venture capitalists (VCs), business angels, and corporate venture capitalists. Furthermore, whatever source of risk capital entrepreneurs choose, they have to take into account the different phases of the investment cycle, i.e., the pre-investment, post-investment, and exit phases. We discuss some of the key issues of which entrepreneurs need to be aware when dealing with venture capitalists during each of these three investment phases. Furthermore, we provide hands-on advice to help entrepreneurs maximize the value of their relationship with VCs throughout the investment cycle, and we point to trouble spots which can endanger value creation. For instance, in the pre-investment phase, the challenges of finding an (adequate) investor, obtaining the right amount of money, and structuring a fair deal are paramount for entrepreneurs. During the post-investment phase, entrepreneurs must attend to managing the relationship with the VC via the creation of effective communication, mutual trust, and the establishment of objectivity and consideration towards the other party. For the exit phase, we discuss the importance of establishing a timely and harmonious exit for the VC. We begin with a brief comparison of venture capitalists in classic venture capital firms with business angels and corporate venture capitalists. The focus of the article, however, is on classic venture capital.

The venture capital (VC) industry has grown radically in size and sophistication over the last 40 years. In 1978, $424 million was invested in VC funds, while in 2004 almost $21 billion was invested (Gompers & Lerner 2001; MoneyTree Survey 2004). The result is a dynamic, often confusing, and at times intimidating world for the uninitiated entrepreneur. This article provides an overview of VC from the entrepreneur’s perspective. It is intended primarily for aspiring entrepreneurs who are in search of risk capital and secondarily for those aspiring to be venture capitalists or angel investors.

The article opens with an overview of the potential sources of equity capital to the entrepreneur—i.e., the different options of risk capital and types of venture capitalists available for an entrepreneur in search of funding for his or her venture. Next, follows a discussion of the different phases of the investment cycle (i.e., the pre-investment, post-investment, and exit phases) with a focus on the dynamics of the relationship between the entrepreneur and one specific type of equity investor, the (classic or professional) venture capitalist (which will be labeled hereafter as the ‘VC’). Finally, the authors use the three phases of the (venture capital) investment cycle to organize a discussion of how entrepreneurs can maximize the value from their relationship with a VC.

Sources of Capital

Entrepreneurs rely on different sources of capital in order to finance their ventures. Often an important source of capital is the entrepreneur’s own capital, or personal savings (Aldrich

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Harry J. Sapienza (hsapienza@csom.umn.edu) is a Professor of Strategic Management and Organization and the Curtis L. Carlson Chair of Entrepreneurial Studies at the Carlson School of Management, University of Minnesota.
Alternatively, serial entrepreneurs—i.e., individuals who launch several ventures over time—may liquidate their stakes in their earlier ventures and re-invest their money in a new venture (Wright, Robbie, & Ennew 1997). A second source of capital may come from informal investors, often referred to (somewhat disdainfully) and collectively as the ‘3Fs’ (family, friends, and fools) of new venture financing. Relatively speaking, the investment amount available or provided via these sources is limited, and these investors’ expectations about a good return are set in an informal way. In many cases, existing personal relationships with the entrepreneur will play an important role in the informal investor’s decision to provide financing (Harrison & Dibben 1997). Another source of funding, at the other end of the spectrum, are banks as providers of capital in the form of loans. However, banks do not wish to assume the high levels of risk associated with equity investing in entrepreneurial ventures. In between these two extremes (i.e., an entrepreneur’s own capital and informal investors on the one hand, and bank loans on the other), there are three major sources of equity finance available to entrepreneurs: (1) classic or professional venture capitalists (VCs); (2) business angels (BAs); and corporate venture capitalists (CVCs). These three investor types differ according to the source of investment funds, typical scope and size of investments, primary motive(s) for investing, investment criteria, reporting requirements, and exit issues. Table 1 compares these three venture capital investor types.

### Venture Capitalists

Venture capitalists (VCs) invest outside equity from professionally managed pools of money. VCs raise funds from various parties (primarily institutional investors) who function as limited partners, in an investment pool referred to as a venture capital fund. In order to maintain limited liability, limited partners are not directly involved in specific investment decisions. The VC therefore

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<tr>
<td><strong>Characteristics of VC Providers</strong></td>
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<tr>
<td><strong>Professional Venture Capitalist (VC)</strong></td>
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<td><strong>Investing funds</strong></td>
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<tr>
<td>● Investing funds of outside limited partners</td>
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<td><strong>Legal form</strong></td>
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<td>● General partnership</td>
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<td><strong>Typical size of investment</strong></td>
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<td>● $2–10M</td>
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<td><strong>Financing stages</strong></td>
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<tr>
<td>● All stages</td>
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<td><strong>Geographic proximity Preferences</strong></td>
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<td>● Close proximity is preferred</td>
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<td><strong>Motive for the investment</strong></td>
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<td>● Equity growth only</td>
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<td><strong>Investment criteria</strong></td>
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<td>● Growth prospects</td>
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<td><strong>Finding investors</strong></td>
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<td>● Easy to find</td>
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<td><strong>Reaching agreement</strong></td>
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<tr>
<td>● Lengthy and extensive due diligence</td>
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<tr>
<td><strong>Reporting requirements</strong></td>
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<td>● Regularly timed reporting requirements</td>
</tr>
<tr>
<td><strong>Involvement level Method</strong></td>
</tr>
<tr>
<td>● Moderate</td>
</tr>
<tr>
<td><strong>Exit planning Method</strong></td>
</tr>
<tr>
<td>● Planned</td>
</tr>
<tr>
<td>● IPO/trade sale</td>
</tr>
<tr>
<td><strong>Business Angel (BA)</strong></td>
</tr>
<tr>
<td>● Investing their own money</td>
</tr>
<tr>
<td><strong>Legal form</strong></td>
</tr>
<tr>
<td>● Private individual</td>
</tr>
<tr>
<td><strong>Typical size of investment</strong></td>
</tr>
<tr>
<td>● $50–100K</td>
</tr>
<tr>
<td><strong>Financing stages</strong></td>
</tr>
<tr>
<td>● Seed &amp; Startup</td>
</tr>
<tr>
<td><strong>Geographic proximity Preferences</strong></td>
</tr>
<tr>
<td>● Very close proximity is preferred</td>
</tr>
<tr>
<td><strong>Motive for the investment</strong></td>
</tr>
<tr>
<td>● Equity growth and personal</td>
</tr>
<tr>
<td><strong>Investment criteria</strong></td>
</tr>
<tr>
<td>● Growth and mentoring prospects</td>
</tr>
<tr>
<td><strong>Finding investors</strong></td>
</tr>
<tr>
<td>● Hard to find</td>
</tr>
<tr>
<td><strong>Reaching agreement</strong></td>
</tr>
<tr>
<td>● Relatively quick to reach agreement when ‘fit’</td>
</tr>
<tr>
<td><strong>Reporting requirements</strong></td>
</tr>
<tr>
<td>● Varies by individual</td>
</tr>
<tr>
<td><strong>Involvement level Method</strong></td>
</tr>
<tr>
<td>● Low to extremely high, informal</td>
</tr>
<tr>
<td><strong>Exit planning Method</strong></td>
</tr>
<tr>
<td>● Often unplanned</td>
</tr>
<tr>
<td>● IPO/trade sale</td>
</tr>
<tr>
<td><strong>Corporate Venture Capitalist (CVC)</strong></td>
</tr>
<tr>
<td>● Investing corporate funds</td>
</tr>
<tr>
<td><strong>Legal form</strong></td>
</tr>
<tr>
<td>● Subsidiary of a large firm</td>
</tr>
<tr>
<td><strong>Typical size of investment</strong></td>
</tr>
<tr>
<td>● $2–20M</td>
</tr>
<tr>
<td><strong>Financing stages</strong></td>
</tr>
<tr>
<td>● All stages, later preferred</td>
</tr>
<tr>
<td><strong>Geographic proximity Preferences</strong></td>
</tr>
<tr>
<td>● Proximity less important</td>
</tr>
<tr>
<td><strong>Motive for the investment</strong></td>
</tr>
<tr>
<td>● Strategic and equity growth</td>
</tr>
<tr>
<td><strong>Investment criteria</strong></td>
</tr>
<tr>
<td>● Strategic value and ‘fit’</td>
</tr>
<tr>
<td><strong>Finding investors</strong></td>
</tr>
<tr>
<td>● Few but easy to find</td>
</tr>
<tr>
<td><strong>Reaching agreement</strong></td>
</tr>
<tr>
<td>● Hard to meet ‘fit’ requirements</td>
</tr>
<tr>
<td><strong>Reporting requirements</strong></td>
</tr>
<tr>
<td>● Regularly timed reporting requirements</td>
</tr>
<tr>
<td><strong>Involvement level Method</strong></td>
</tr>
<tr>
<td>● Low to moderate</td>
</tr>
<tr>
<td><strong>Exit planning Method</strong></td>
</tr>
<tr>
<td>● Acquisition/trade sale/IPO</td>
</tr>
</tbody>
</table>
manages the fund for his or her limited partners by making investments in a portfolio of entrepreneurial ventures (Sahlman 1990).

A group of VCs who co-manage one or more VC funds is referred to as a venture capital firm. Because of the limited life (typically 10 years) of a venture capital fund, venture capital firms commonly have more than one fund under management at all times. Some very large firms even have multiple funds, each of which may be specialized by industry sector or stage of development (Norton & Tenenbaum 1993). The total amount of money a venture capital firm has under management in its various funds varies with firm strategy and reputation. Most venture capital firms have between $100 to $500 million in capital under management. Investment decisions are made collectively by the individual VCs who act as partners of the venture capital firm (for convenience, we refer to the venture capital firm itself as ‘firm’ and to the investee as ‘venture’). These partners are also involved in the venture capital firm’s day-to-day operations. Venture capital firms are small, flat organizations (Wasserman 2005; 2003). The firm receives an annual management fee (typically 1 to 2.5 percent of the fund’s committed capital) from its limited partners; this fee covers expenses of managing the fund, including the salaries for the VCs. The venture capital firm also receives a share (commonly 20 percent) of the profits of the fund (typically called ‘carried interest’ or simply ‘carry’) that is divided up among the VCs. Because the most successful of ventures may generate more than $100 million in return at exit, a VC can become wealthy with but one highly successful venture investment.

As an industry, classic venture capital firms invest in all stages of venture financing, although some individual firms focus on particular venture stages. Among other names, these stages are sometimes referred to as seed, start-up, expansion, and buyout. Compared to BAs (see below), VCs invest, but modestly, in seed financings (Wright & Robbie 1998). Seed financings are where the venture is still developing its technology and/or business concept. Funds for a seed financing are used to develop the technology and business concept to the point where the venture can attract start-up financing. Table 2 provides some background information in comparing financing stages in terms of the venture’s characteristics, the purpose of the funding, the typical VC investor, the benefits provided by the VC, and the major trouble spots. Where appropriate, Table 2 points out differences by stage among VCs, BAs, and CVCs.

VCs are interested in growth and increasing the value of the venture when making investments. Therefore the growth potential of entrepreneurial ventures and the capability of the management team to realize this growth are paramount to VCs. VCs typically focus on the track records of the entrepreneurs. In the earliest stages, the world-class status of the entrepreneurs is especially important. As time goes on, the demonstrated ability of the CEO to bring venture to the market increases in importance. It is not unusual for the CEO to be replaced as the venture growth explodes (Tybee & Bruno 1984; Wright & Robbie 1998). In order to assist in growth and to monitor progress, VCs stay highly involved with their portfolio companies and expect regular reporting from the entrepreneur (Busenitz, Moesel, & Fiet 2004). Whereas entrepreneurs are especially interested in maintaining ownership control of the venture, this issue is only of indirect interest to the VC. VCs want to make sure the entrepreneur stays motivated; the VCs do not want to run the entrepreneur’s business. However, although an individual VC rarely takes a majority stake in the venture, VCs often insist that control of the board of directors and of future equity dilution decisions be in the hands of a syndicated group of venture capital investors. These preferences imply that entrepreneurs should not come across as being obsessed with ownership percentages. Rather, entrepreneurs should portray themselves as wanting a fair deal for all.

The preferential exit mechanisms for the VC are an initial public offering (IPO) and trade sale. The route to exit is preferably planned before the investment is made. VCs have developed highly standardized terms of agreement and prefer to let their lawyers hammer out the details of the agreement with the entrepreneurs’ lawyers so as to minimize last minute personal acrimony between themselves and the entrepreneurs.
**Business Angels**

Business angels (BAs) are individuals who invest their own capital in new ventures. BAs are often either entrepreneurs (who have sold their companies and wish to invest their money) or retired senior executives of large companies. BAs share the VC’s interest in equity growth, but many are also drawn to venture capital investing by the chance to be heavily involved in an exciting venture where they have the opportunity to leverage their industry contacts and expertise and/or to mentor the development of a promising young entrepreneur. As a result, BAs are inclined to invest in businesses where they have knowledge and experience (Harrison & Mason 1996). An important issue for the entrepreneur will be to determine whether the BA’s primary interest is to generate a profit or to mentor as well. The former type of BA will resemble the VC in many ways and the latter will want closer ties and involvement with the entrepreneur; in this latter case, meddling can become an issue for the entrepre-

<table>
<thead>
<tr>
<th>Table 2</th>
<th>Issues Related to VC Investing by Venture Stage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Seed Financing</td>
<td>Start-up Financing</td>
</tr>
<tr>
<td>Characteristics of the venture</td>
<td>Management team in place</td>
</tr>
<tr>
<td>● 1–2 entrepreneurs</td>
<td>● Product ready for marketing</td>
</tr>
<tr>
<td>● Undeveloped technology and business concept</td>
<td>● A pilot and other information about the product are available</td>
</tr>
<tr>
<td>● Business plan is not validated</td>
<td></td>
</tr>
<tr>
<td>Main purpose of the funding</td>
<td>Establishing the marketing and sales activities</td>
</tr>
<tr>
<td>● Enabling research and development</td>
<td></td>
</tr>
<tr>
<td>● Developing business concept</td>
<td></td>
</tr>
<tr>
<td>Typical venture capital investor</td>
<td>VC</td>
</tr>
<tr>
<td>● Business angel (BA)</td>
<td></td>
</tr>
<tr>
<td>● Sometimes corporate venture capitalist (CVC)</td>
<td>VC</td>
</tr>
<tr>
<td>Main expertise or benefit beyond money provided by the venture capitalists</td>
<td>Marketing experience, recruiting help, contacts, help with follow-on financing (VC)</td>
</tr>
<tr>
<td>● Structure, discipline, sounding board and attraction of additional (external) funding (BA, VC, CVC)</td>
<td>Technical insights, test marketing and piloting possibilities (CVC)</td>
</tr>
<tr>
<td>● Insights how to establish the venture’s legal form (VC)</td>
<td>Reputational benefits (VC, CVC)</td>
</tr>
<tr>
<td>● Technological insights (CVC)</td>
<td></td>
</tr>
<tr>
<td>Major trouble spots of venture capital funding from entrepreneurs’ point of view</td>
<td>Time consuming to locate, negotiate and close the deal</td>
</tr>
<tr>
<td>● Time consuming to locate, negotiate and close the deal</td>
<td></td>
</tr>
<tr>
<td>● Involvement (e.g. reporting requirements and governance) with a VC requires a lot of time</td>
<td></td>
</tr>
<tr>
<td>● Early stage company does not have very much to back up the valuation of the venture and the valuation might be very low</td>
<td></td>
</tr>
</tbody>
</table>

2006 De Clercq, Fried, Lehtonen, and Sapienza
neur. Typically, BAs will take modest levels of ownership in the new venture, averaging 10 to 15 percent of ownership in initial deals.

BAs rarely compete with VCs for deals. Rather, they either invest in seed stage deals that they hope will develop into ventures that attract start-up financing from VCs, or they invest in ventures whose growth prospects are too small to be of interest to a VC. In the case of the lower growth potential ventures, the BA still seeks good returns, but the absolute value of the potential return can be much smaller than the VC’s because the amount invested is significantly less. For entrepreneurs who favor informal relationships with their investors and prefer light reporting requirements, BAs may represent an appropriate source of risk capital. Furthermore, because extremely high growth is rare for BA-backed ventures, the main exit mechanism is trade sale. Oftentimes, the specific exit type is unplanned. Agreements will be much less formal and standardized than with VCs. And, while lawyers are typically involved in capturing the final agreement, the terms are usually directly negotiated between the BA and the entrepreneur.

**Corporate Venture Capitalists**

Corporate venture capitalists (CVCs) are another source of equity finance for the entrepreneur and reside at the other end of the venture development spectrum from BAs. The CVC acts as a financial intermediary of a non-financial company (Siegel 1988). While CVCs are interested in equity growth on their venture investment, their primary interest is in securing strategic benefits for their parent operating company. CVCs seek to make money indirectly for their corporate parent by investing in ventures that add value to their parent. For example, the CVC of a pharmaceutical company may invest in a start-up that is developing a new drug that its parent company will ultimately distribute. Other times the CVC may invest in the hope that if the venture is successful, then the CVC’s parent company will have the inside track on ultimately acquiring total ownership of the venture. As a result, corporate venture capital investments are primarily made in ventures whose line of business is closely linked to the parent’s existing business. Entrepreneurs should be aware that a CVC whose parent is well-recognized in the marketplace can provide substantial benefits such as access to distribution channels, R&D support, and direct sales to the mother company. Furthermore, the reporting requirements expected by the CVC are rather strong for the entrepreneur and often focus on the strategic fit between the investor (corporate parent) and investee (entrepreneur). A common exit method for the CVC is acquisition or trade sale, and the exit route is often unplanned.

From the entrepreneur’s point of view, a major danger with CVCs is the appropriation of technology secrets or know-how by the CVC. Also, if the venture is acquired by the CVC, entrepreneurs are likely to lose operating control of the venture, and the entrepreneurial culture of the venture is also threatened. CVCs are less concerned with venture exit; instead they leave the conditions open to their evaluation of the strategic usefulness of the venture to their parents’ core operation. Terms tend to be standard and formally negotiated.

Entrepreneurs should be aware that VCs, BAs, and CVCs represent partially complementary and partially overlapping sources of finance. The complementary involves two dimensions—namely, the timing and amount of capital provided. BAs tend to be more willing than VCs to invest at the very earliest stages; however, the amount of funding available for a single infusion is much larger from VCs and CVCs than from BAs. In general, VCs are more risk averse and prefer shorter investment horizons. Furthermore, BAs are more highly motivated by the intrinsic reward of their involvement in the management of the venture. Since CVCs emphasize technology and the line of the business of the venture, they make investments of varying size, often in conjunction with BAs and VCs. The strategic interest CVCs take in the venture means that they are often willing to pay higher prices for equity but also present a significant threat of using the venture’s knowledge to create direct competition for the venture.

Entrepreneurs should be interested not only in the money a potential investor can provide, but also in their potential to add value beyond cash.
In fact, in some cases, the potential value-adding services can be the primary reason for entrepreneurs to seek venture capital, as illustrated by the notable example of Microsoft in its pioneer years (Wilson 1985):

Money alone was certainly not what won David Marquardt (a VC at a firm called TVI) a chance to put $1 million into Microsoft Corp... The company... was generating more cash than it could use when Marquardt heard in the Fall of 1980 that Gates was interested in lining up his first outside investor. ‘They absolutely didn’t need our money, but they wanted outside counsel and I was the first venture capitalist they had talked to who understood their business.’ Marquardt, who had been a computer hobbyist for years, spoke Gate’s language well enough to win a place on the Microsoft board of directors.

The Venture Capital Investment Cycle

Regardless of the type of venture capital the entrepreneur has chosen to seek, entrepreneurs will have to take into account the phases of the investor’s investment cycle and the impact of these phases on their financial and social relationship with the investor. Overall, three phases can be distinguished in the VC investment cycle: the pre-investment, post-investment, and exit phases (Tyebjee & Bruno 1984). These phases will be used to organize the discussion for the remainder of the article. The flow chart in Figure 1 summarizes the different steps included in the investment cycle. Whenever possible, we will pinpoint what the implications are for the entrepreneur when discussing the investor’s activities and preferences in the different phases.

Because entrepreneurs’ motives for attracting venture capital differ, they should keep in mind that different types of investors can play different and complementary roles in their venture. Table 3 compares the different investor types across the different phases in the investment cycle. In the remainder of the article, the focus is on VCs, only (although Table 3 can be used throughout to compare the investor types in different phases of the venture capital cycle). An emphasis on this sector was chosen for two reasons: (1) the longer history of the professional venture capital sector has resulted in a common set of practices from which lessons and insights can be drawn; and (2) classic venture capitalists are popularly believed to have developed the most sophisticated and best practices in nurturing new ventures. In short, both entrepreneurs and other investor types can learn much by understanding classic venture capital (Wright & Robbie 1998; Bruton, Fried, & Manigart 2005; Kummerle 2001; Sapienza, Manigart, & Vermeir 1996; Wright, Lockett, & Pruthi 2002).

Pre-Investment Phase

The VCs’ goal in the pre-investment phase is to make an investment in a venture that offers the potential for significant long-term capital gains. Their target rates of return are about 30 to 60 percent per annum; thus, to qualify, a venture must have a realistic chance of achieving significant growth in sustainable earnings and offer an exit opportunity in three to seven years after the investment (Sahlman 1990).

For the entrepreneur, it is crucial to understand what VCs are looking for when making investment decisions. In essence two aspects are important. First, the venture needs to offer an excellent business opportunity. More specifically, a VC would define such opportunity as huge market potential; appropriate venture strategy with a goal of establishing and maintaining uniqueness; adequate protection of intellectual property from imitation; and a well-developed and integrated marketing, production, and financial plan (Shane 2003). Furthermore, VCs look for a concept that can be implemented in a reasonable time with a reasonable amount of capital. VCs are not interested in funding basic research. The concept must offer a sustainable competitive position that will generate a significant level of absolute profit if successful. This means that VCs are generally looking for concepts that address markets of at least a half-billion dollars in size.

Second, the venture should be led by an excellent entrepreneur and management team—one that shares the VC’s growth and value maximization goals. VCs want management that is honest, trustworthy, motivated, and passionate about the venture. However, as many entrepreneurs may have (or pretend to have) these characteristics, the most critical distinguishing factor is the entrepreneurs’ experience. A variety of types of ex-
perience are critical: experience in the start-up process itself (including selecting and motivating a high-quality team); experience in the target industry (including understanding key success factors and crucial value chain activities, as well as possessing reliable and venture-friendly access to distribution channels); and cutting-edge technology experience (including knowledge of and access to the key people and techniques in the field).

One study referred to the following two key aspects in the VC's decision-making process: the entrepreneur's educational capacity (i.e., the availability of general skills that enable the perception of, and enactment upon, market opportunities) and industry-related experience (i.e., the presence of considerable experience within the management team in terms of the industry that is being entered by the venture) (Shepherd 1999a). Another study pointed to the importance of the entrepreneur having successfully completed a

![Figure 1: Steps in the Investment Cycle](image-url)
product development project or funding round; still another examined the different kinds of experience needed in different phases of the investment cycle (Wasserman 2002). Interestingly, what many VCs perceive as the necessary extent of experience has varied over time. At the height of the Internet bubble, many VCs invested (often to their deep regret) in ventures headed by entrepreneurs with just a few years of experience. Now, even early-stage investors want to see a CEO in place whom they feel is capable of managing the company all the way to exit. The current preference is for someone with top management experience (or at least full profit-center responsibility), going from early stage to exit, in a successful company. If the VC is interested in an emerging venture, but views the entrepreneur as too inexperienced, a VC might still offer seed investment with the explicit understanding that more experienced management must be in place before start-up financing is provided. In short, entrepreneurs should be aware that investors want to know whether the entrepreneur is as interested in growing the venture as are the investors themselves, and is willing to step aside if doing so will improve the venture’s prospects.

VCs’ select investments through an informally structured (but relatively uniform) process usually contain the following phases: deal origination,

Table 3
Issues by VC Type and Investment Phase

<table>
<thead>
<tr>
<th></th>
<th>Professional Venture Capitalist (VC)</th>
<th>Business Angel (BA)</th>
<th>Corporate Venture Capitalist (CVC)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Pre-investment phase</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deal origination</td>
<td>● VCs tightly knit community</td>
<td>● BAs hard to locate</td>
<td>● CVCs usually ‘tag along’ with VCs</td>
</tr>
<tr>
<td></td>
<td>● Referrals are highly valued</td>
<td>● Internet, informal networks and university groups may be used</td>
<td>● May be best to find VCs that regularly partner with CVCs</td>
</tr>
<tr>
<td>Deal screening</td>
<td>● Defined targets</td>
<td>● Difficult to know a priori what investor’s preference is</td>
<td>● Multiple strategic foci</td>
</tr>
<tr>
<td></td>
<td>● Check stage, industry, location, and capital needed</td>
<td>● Typically informal pitch</td>
<td>● Formal pitch</td>
</tr>
<tr>
<td></td>
<td>● Formal pitch</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Deal evaluation</td>
<td>● Extensive due diligence</td>
<td>● Criteria/process investor specific</td>
<td>● Extensive due diligence (proprietary knowledge at issue)</td>
</tr>
<tr>
<td>Deal structuring</td>
<td>● Valuation</td>
<td>● Fewer restrictive terms</td>
<td>● Follows VC lead</td>
</tr>
<tr>
<td></td>
<td>● Formal control by the VC</td>
<td>● Lack of sophisticated terms may cause later financing problems</td>
<td>● Intellectual property rights are key issue</td>
</tr>
<tr>
<td></td>
<td>● Use of ‘term sheet’</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>● Staged investing</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Post-investment phase</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Monitoring</td>
<td>● Milestones</td>
<td>● Informal control</td>
<td>● Corporate control</td>
</tr>
<tr>
<td></td>
<td>● Board representation</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>● Reporting requirements for entrepreneur</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Value-adding roles</td>
<td>● High to moderate</td>
<td>● Low to moderate</td>
<td>● High to moderate</td>
</tr>
<tr>
<td></td>
<td>● Roles: strategic, financing, networking, interpersonal, reputational, discipline</td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Exit phase</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Exit planning</td>
<td>● Planned</td>
<td>● Often unplanned</td>
<td>● Often unplanned</td>
</tr>
<tr>
<td>Exit mode</td>
<td>● IPO/Trade sale</td>
<td>● Trade sale</td>
<td>● Acquisition/Trade sale/IPO</td>
</tr>
</tbody>
</table>
deal screening, deal evaluation, and deal structuring. The process generally takes the VC in excess of 100 hours of work over about a three-month timeframe before making an investment. Less than 2 percent of the deals that enter the process ultimately receive an investment from the VC (Fried & Hisrich 1994).

In the deal origination phase, the entrepreneur and the VC initiate contact with one another. VCs make themselves known through active participation in entrepreneurial networking events and their websites (e.g., NVCA.org has a list of all member firm websites). The entrepreneur can also learn about VCs through published industry guides (e.g., Pratt’s Guide to Venture Capital or West Coast Venture Capital) and more in-depth information services (e.g., VentureOne Corporation, Venture Economics, and Securities Data Corporation). Some VCs like to identify potential deals and then initiate contact with the entrepreneur. However, most VCs focus their efforts on developing and maintaining a broad network of people who refer deals to them. VCs are much more apt to invest in deals that are based on referrals, rather than in deals that come in cold. Referrals come from a variety of sources, such as commercial bankers, lawyers and accountants, consultants, managers of success entrepreneurial companies, and personal friends (Shane & Cable 2002). Referrals give the VC some confidence that the entrepreneur is a trustworthy party, especially if the entrepreneur has little history or reputation in the VC community.

In fact, often the referral comes from another potential investor. It is a common practice for deals to be syndicated among multiple investors (Bygrave 1987). Syndication allows both different investor types (i.e., VCs, BAs, and CVCs, see Table 1) or all of one type to share the risk of an individual investment and increase the number of quality investments they can make. Syndication also allows investors to pool efforts in the deal screening, evaluation, and structuring phases (Brander, Amit, & Antweiler 2002). For instance, one reason professional VCs may bring a deal to corporate VCs is for the latter to provide help in evaluating the technology. Once the deal has been made, investors often make different value-added contributions. For example, a VC may invite a BA to invest in a start-up in an industry where the BA has significant experience. The VC does not want the BA’s money; rather, the VC wants the venture to benefit from the BA’s industry expertise and contacts. Often two or three such investors may require seats on the venture board in order to do the deal. However, filling up the board with investor-types can be burdensome and redundant. Entrepreneurs should seek information both on the potential value-added contributions of the investors in their investment syndicate and on the style of governance in which they typically engage.

In the deal screening phase, the focus is on whether the venture meets the VC’s interest in terms of industry sector, investment stage, geographic location, and amount of capital needed (Shepherd 1999b; Zacharakis & Meyer 2000). Assuming a potential fit, the VC then makes a quick evaluation regarding whether the venture has a realistic chance of being a worthwhile investment. Because the subsequent evaluation phase requires a great deal of VC time, the VC tries to limit the number of investments entering that phase. As a result, most investment proposals are eliminated by the VC, based solely on a cursory reading of the plan or a brief chat with the entrepreneur. An important step in the screening process typically is a personal meeting by the entrepreneur with the VCs in the venture capital firm. This meeting often takes about an hour and involves a ‘pitch’ by the entrepreneur and extensive questioning by the VCs. The meeting may result in the exchange of knowledge useful for both parties, as well as the development of a feeling as to whether there is good ‘chemistry’ between the parties.

If the entrepreneur is still under consideration, the critical third stage is begun. In the deal evaluation phase (also called due diligence phase), the VC engages in a very in-depth evaluation of the venture. The VC engages in a variety of information gathering and background checks, generally through informal methods, to determine if the business plan presented by the entrepreneur is realistic and achievable by the venture’s management. This phase also includes the interviewing
of, and extensive reference checking on, all members of the management team.

Finally, in the deal structuring phase, the entrepreneur and VC negotiate the valuation of the venture to be used in pricing the equity securities the VC is purchasing. In determining the price, the VC is driven by his or her expectations of the likely value of the venture at the time the VC anticipates exiting. Theoretically, valuation is determined based on projected earnings and market-comparable PE ratios at the time of exit. However, in early stage ventures, the actual equity received for a given level of investment is much more likely to be determined by prevailing norms than any actual calculation of realistically expected future cash flows. In essence, the VC needs to believe that the target rate of return has a reasonable chance of being reached within her required time to exit. With multiple investors involved and with great future uncertainty, the end result is that VCs generally receive significant ownership stakes in their ventures, especially in those receiving money in early stages. For instance, Moneytree reported that the average early stage deal size equaled $4.6 million in 2004, with VCs receiving approximately 50 percent ownership (i.e., summed across VC members of the syndicate) of the venture in early-stage deals (MoneyTree Survey 2004).

In addition to price, many issues are involved in structuring the deal. Particularly important to the entrepreneur is the extent of control that the VC can exercise, e.g., the composition of the board of directors, types of spending that require VC approval, the mechanisms given to the VC to force a future exit event, or the terms of the top management’s employment contracts (Bouillet-Cordonnier 1992; Kaplan & Stromberg 2003; Triantis 2001; Sahlman 1990). For instance, VCs often require entrepreneurs to issue convertible preferred stock that gives the VC a liquidation preference if the venture does not perform well, but also common stock ownership in the event that the venture succeeds. Such provisions effectively ensure that entrepreneurs whose ventures do not succeed will be able to salvage very little from the venture. However, in the U.S. this structure is also extremely advantageous to the entrepreneur from an income tax standpoint (Gilson & Schizer 2003). VCs may also include a variety of covenants in their agreements with entrepreneurs. For instance, they may prohibit the entrepreneur from purchasing assets or issuing or selling shares without their permission. They may also demand mandatory redemption rights that require the venture to purchase their investment back. Furthermore, VCs may employ forfeiture provisions that cause entrepreneurs to lose ownership if their performance falls below target goals. Interestingly, there may also be informal control mechanisms within the venture’s management team. This is illustrated by the Cisco case in which the founders, Sandy Lerner and Leonard Bosack, had to step down (Fortune 1995):

After Cisco had made a successful IPO, Sandy Lerner’s role had made her rich, but with her role diminished and her company moving further away from its roots, she was deeply unhappy. Increasingly, she began lashing out. The other executives, however, believed that her behavior had become a huge, unnecessary distraction. At some point, they went to the VC (i.e., Don Valentine) and told him, in essence, either she goes or we go. In December 1990 both founders sold every share of their stock in the company.

In short, given the high risks to which they are exposed, VCs typically include tough provisions that give broad powers to ensure participation in the upside and minimize exposure to malfeasance. Clearly, many restrictions are harsh and perhaps even unfair, leaving great room for potential disagreement over the deal structure, particularly as to valuation and control. Often a VC very interested in a deal will choose not to invest because he or she cannot agree upon the terms with the entrepreneur.

Since the evaluation process is time-consuming for both parties, it is common to negotiate the major terms of the deal before the VC starts extensive due diligence. Thus, terms that are deal-breakers are identified and negotiated before either side gets too far into the process. The result of this negotiation is a written document, commonly referred to as a ‘term sheet.’ It summarizes the major terms of the potential VC investment. If the outcome of the due diligence process is favor-
able, then the VC will make an investment subject to the terms outlined in the term sheet. The actual closing of the investment transaction requires a plethora of detailed legal documents that are negotiated in detail at the end of the selection process. As mentioned earlier, because many of the term sheet issues have been difficult and emotional, often the details of closing are handled by the parties’ lawyers with little direct involvement from either entrepreneur or VC. While the term sheet is not binding on any party, it is unusual for ‘deal breakers’ to arise when the final legal documents are drafted.

A particularly important issue for many entrepreneurs is the common practice among VCs to stage their investments across multiple rounds of financing. VCs prefer to stage their investments because this reduces the amount of money invested at the earliest stages of development when risk is highest (Sahlman 1990). If the venture develops properly, more money is invested backing this potential winner. If the venture does not develop as desired (i.e., the milestones are not met), the VC either cuts losses by simply not funding the next financing round or alternatively invests at a lower valuation of the venture. For the entrepreneur, a staged practice approach poses an obvious risk. If the venture does not develop as planned, the venture will soon be out of money and in a very poor position to raise more money. In addition, when negotiating an early round the entrepreneur must be aware that his or her percentage ownership in the venture will be significantly diluted in subsequent rounds even if the venture develops as planned. One study found that founder ownership decreased from 28.9 percent immediately after the first round of VC funding to 12.4 percent immediately before the IPO, then to 8.8 percent immediately after the IPO (Kaplan, Sensoy, & Stromberg 2005). However, a staged approach to financing also offers a major advantage to the entrepreneur. If the venture develops as envisioned (or better), the entrepreneur will end up with a larger share of the company if investments are delayed than if all the money is invested in the first round. Entrepreneurs will end up with a larger share because the required IRR for the VC’s investment is typically lower in later rounds as the level of risk decreases (i.e., the valuation of the company goes up in subsequent rounds), thus shifting investment to a later round lowers dilution. The key for the entrepreneur, therefore, is to receive adequate money to get to the next stage and to set hurdles that are measurable and achievable. Many entrepreneurs have learned that setting huge growth targets to impress investors can be self-defeating. It is best to ‘underpromise and over-deliver.’ In short, from the discussion above, it follows that entrepreneurs are faced with ‘conflicting’ objectives when negotiating a deal structure with an investor, i.e., to give up as little equity as possible, to get as much cash as possible, and to set milestone hurdles as low as possible. Entrepreneurs should be aware that the simultaneous accomplishment of these goals may not be possible.

Post-Investment Phase

In terms of the post-investment phase, the VC is essentially engaged in two types of activities: monitoring and providing value added. As with any investor, the VC spends time monitoring the performance of the investment. These monitoring activities reduce the agency risks associated with VC-entrepreneur relationships (Sapienza & Gupta 1994). However, the VC is a much more active monitor than are other investors (such as banks) for several reasons. First, the VC’s investment is illiquid. Unlike the public market investor, the VC cannot sell his or her investment on a moment’s notice (Sahlman 1990). Second, there is much uncertainty involved with a venture receiving venture capital, so the VC has to spend more time determining what is happening now and what should happen in the future (Sapienza & Gupta 1994). Third, the VC is paid by his or her own investors to monitor the fund’s investments. The VC’s ability to raise future investment pools is heavily impacted by the investment performance of earlier pools that he or she managed (Sahlman 1990). Finally, VCs often have a significant personal investment in the fund and much of their compensation is directly tied to the fund’s investment performance (Gifford 1997).

In order to facilitate monitoring activities, VCs receive strong control levers. As mentioned ear-
lier, VCs often engage in staged investing, and generally invest in convertible preferred stock that carries the same voting rights as if it had already been converted into common stock (Gompers 1998). Furthermore, a significant board representation allows for the replacement of the entrepreneur as chief executive officer if performance lags. Also, entrepreneurs should be prepared to provide regular reports to their VC, ones to which VCs will pay close attention and upon which they will rely in board meetings, as illustrated by the following quote from an entrepreneur (Fried & Hisrich 1995):

They [VCs] know general types of goals that we might have. An example would be an average day's outstanding on accounts receivable. They might call up and say: 'You know, at the last board meeting you thought you could get average day's outstanding down to so and so. How do you think you're doing?'

However, entrepreneurs should also understand that most VCs do not want to tell entrepreneurs how to make day-to-day operations nor have them report on a daily basis. They basically want the entrepreneur to run the venture profitably; they want merely to be consulted on any major decision (Gifford 1997).

VCs’ post-investment activities often go well beyond monitoring the investment. VCs are value-added investors; that is, they add value to their ventures (Busenitz, Moesel, & Fiet 2004; Dimov & Shepherd 2005; Edelman 2002; Sapienza 1992). From the entrepreneur's point of view, the presence of added value beyond cash may more than compensate for the high cost of VC financing. From the VC’s perspective, the provision of value-added services increases the average return on investment. For example Vinod Khosla, an early-stage investor and general partner at Kleiner, Perkins Caufield & Byers, indicated that when he took on an active role in portfolio companies his aggregated returns were approximately 70 percent, while when he was a passive investor his aggregated returns were only around 8 percent (Pratch 2005).

Fund, and its portfolio companies as reported in Pratch (2005).

Strategic Role
The VC serves as a ‘sounding board’ to the entrepreneur and the venture’s top management on a variety of key decisions in the life of the venture. Rather than making decisions for the entrepreneur, the VC prefers to provide advice to the entrepreneur, reflecting on the entrepreneur’s ideas and making suggestions (Sapienza 1989). Entrepreneurs can often expect helpful advice on strategic and marketing issues as well as on issues related to organizational development based on the VC’s understanding of the entrepreneurial process (Prutch 2005):

Vesbridge Partners’ strategic support and insight led one of its portfolio company, Granite Systems, to rewrite its software. The software was marketed to carriers that used it to digitally maintain network inventory. Vesbridge used its deep telecom industry knowledge to guide the change which was necessary to ensure long-term success of the portfolio company though it was a very risky move.

Financing Role
The VC is often very active in developing capital strategies for the venture, arranging financing from other investors such as VCs, banks, and others (Lerner 1994). Furthermore, VCs play a significant role as a venture moves toward an initial public offering or acquisition (Gladstone & Gladstone 2003; Megginson & Weiss 1991). Entrepreneurs can also benefit from VCs’ assistance in developing strong internal financial management procedures (Pratch 2005).

Networking Role
The VC often has a very large network of contacts with expertise in start-up problems, issues, and solutions. Entrepreneurs benefit from these networks when looking for external managers, addi-
tional financing opportunities, key service providers, acquisition candidates, or customers (Pratch 2005).

A well connected general partner from Vesbridge Partners introduced Mahi Networks, one of the firm’s portfolio companies active in the telecom sector, to Bell South, British Telecom and AT&T, all major carriers that could become significant customers for Mahi Networks.

Interpersonal Role

The VC often serves as a mentor, friend, and confidant to the entrepreneur. Running a fast-paced, high-potential venture is demanding, stressful, and uncertain. On sensitive internal issues, the entrepreneur may be more comfortable talking with the VC than with members of his or her own top management team, fearing to share misgivings and doubts with other top managers. At times even a spouse or close friend cannot understand what the entrepreneur is going through or give any kind of useful advice. The VC often can provide the type of moral support in times of crisis unavailable anywhere else (Pratch 2005).

Vesbridge Partners provided a lot of organizational and management experience to a 28 years old CEO with scientific background who was in charge of one of its portfolio companies. This support as mentor helped the CEO avoid many beginner’s mistakes.

Reputational Role

The involvement of a VC, particularly one with a history of backing successful ventures, can significantly enhance the reputation of the venture. This can be vital for the entrepreneur in persuading a variety of potential stakeholders to get involved. A venture with VC involvement is much more likely to be viewed as a potential winner by these stakeholders. This reputational benefit can come into play in the recruiting of top management, getting initial sales from key customers, attracting other investors, attracting investment bankers, and winning acceptance in the public market for an IPO (Pratch 2005).

Vesbridge Partners made it clear during 2001 that it believed in Mahi Networks, regardless of the telecom industry’s downturn and the fact that the majority of the VCs were pulling out of the telecom industry. As a sign of commitment, Vesbridge acted as one of the leading investors in Mahi’s financial round. Because of Vesbridge’s strong support Mahi was able to raise altogether $75 million of VC funding.

Discipline Role

A major role of the VC is in the evaluation and, if necessary, replacement of management. The entrepreneur may dispute the ‘value added’ aspect of this discipline. But such a role may represent value added to the venture as whole, not the entrepreneur individually. Replacing a CEO who is performing poorly is a vital, if unpleasant, way in which VCs add value (Fried, Bruton, & Hisrich 1998). VCs also contribute discipline in less intrusive ways. A hallmark of the VC is continual pressure on the entrepreneur to focus on attaining agreed objectives. While at times unpleasant, many entrepreneurs view this disciplinary contribution as vital to their success (Pratch 2005; Sapienza 1989).

In the case of Aegis Semiconductor, one of Vesbridge Partners’ portfolio companies, the venture capital firm considered the CEO to be too interested in technology (rather than sales). The VC convinced the CEO to step aside and a new CEO was recruited who was able to concentrate on sales and other needs of the company.

Exit Phase

VCs insist on a clear exit strategy that enables them to convert their non-liquid equity position in a private company into cash or publicly traded stock. The investment funds they manage are generally not operated on a going concern principle, but instead have a pre-determined liquidation date. Exit generally occurs by: (1) the venture going public (IPO) and the VC selling his or her stock in the public stock market; (2) the venture being sold (trade sale) in its entirety; (3) the venture buying back the VC’s stock; or (4) the venture being liquidated and the proceeds, if any, going to the VC after creditors have been paid off.

For many VCs, the preferred exit route is the IPO, because the public market tends to value companies higher during an IPO than in trade sales. In fact, VCs often use the potential for a company to go public as leverage in extracting the
The IPO exit also tends to be favored from the entrepreneur’s perspective. An IPO is a way to raise equity capital to fund current and future operations without giving up operating control of the venture. For instance, Amazon.com went public in May 1997 and raised over $40 million by selling stock to the public, with management still firmly in place. To the entrepreneur, the IPO provides a high valuation, but limited liquidity. In addition to being subject to the same legal constraints on selling stock as the VC, public markets are highly adverse to any large stock sales by the entrepreneur. It is viewed as a signal that the company is not doing well. However, limited liquidity is not a problem to many entrepreneurs. They want to remain with the company long-term. Besides keeping his or her job, entrepreneurs can actually increase their control over companies through an IPO. While the entrepreneur’s percentage ownership will go down as a result of the IPO, the entrepreneur is trading a large, powerful and active shareholder (the VC) for the highly fragmented, nearly powerless, shareholders of the public market (Black & Gibson 1998).

While the IPO may be the preferred route for many VCs and entrepreneurs, realities of the public market place make the trade sale by far the most common route (Relander, Syrjanen, & Miettinen 1994). Although the trade sale may result in a lower value, it does provide immediate, full liquidity to both entrepreneur and VC. It also means, however, that the entrepreneur loses all control over the company, and likely his or her job as CEO. If the venture is strategically important to a large company, the prices realized through trade sale can compare favorably with an IPO. In general, when the IPO market is good, trade sales values are high and vice versa.

Another exit means is a buyback of the VC’s stock by the venture. A buyback differs from a trade sale in that the VC exits, but the entrepreneur remains. The entrepreneur’s control increases by eliminating the VC as a shareholder. However, it often results in much of the venture’s future cash going to reduce debt incurred to finance the buyback.

Finally, liquidation is not a happy route for any party. A liquidation is the sell-off of the assets of the venture for their salvage value. Proceeds go to security holders (after paying back taxes, accounts receivable, etc.) in the order of seniority of the debt and equity instruments. It almost always results in the VC losing some, often all, of the original investment. This scenario is even worse for the entrepreneur, who rarely gets any money back, loses a job, and watches a dream die (D’Aveni 2005; Cumming & MacIntosh 2003).

Maximizing the Entrepreneur-VC Relationship

Having a VC on board for a venture may be a huge benefit to an entrepreneur, yet there is also the potential for major problems. The remainder of this article focuses on hands-on advice regarding how the relationship between entrepreneur and VC can be maximized from the entrepreneur’s perspective, organizing the discussion according to the three investment phases and pointing out likely trouble spots along the way. Table 4 provides a summary of the major points presented.

Pre-Investment Phase

In the pre-investment phase the entrepreneur’s first and most difficult task is locating a VC who is willing to invest. However, more is involved than just getting venture capital. The entrepreneur should also find the right investors, secure the right amount of money, and obtain a deal structured in an equitable manner.
Getting Venture Capital

Just getting the VC to spend time seriously evaluating a deal is often a challenge for the entrepreneur. The VC starts with a limited knowledge of the deal. To gain the level of knowledge necessary to make a positive investment decision requires time, yet VCs’ time is limited and many potential deals vie for it (Gifford 1997). VCs want to invest only in the very best of deals. Investing in a mediocre deal is a bad decision from the VC’s point of view. On the other hand, the entrepreneur of a mediocre deal has great incentive to get the VC to invest. Furthermore, the quality of a deal is uncertain and highly subjective. VCs experience a high variance in returns from their investments (Cochrane 2005). What the VC in good faith views as a weak deal, the entrepreneur may in equally (and often very passionate) good faith view as a great deal. There are several things an entrepreneur can do to increase his or her chances of attracting venture capital (Fried, Brunton, & Hisrich 1998).

- Secure a Good Referral. As discussed earlier, referred proposals are much more likely to get funded by the VC than proposals that come in cold. Both the entrepreneur’s lawyer and CPA may be able to help, as well as friends and industry contacts who may know VCs (Shane & Cable 2002). For a later stage transaction, an investment banker is sometimes helpful. However, investment bankers are rare in early-stage investing, as early-stage VCs generally balk at cash fees being paid out by an early-stage company.
- Write a Good Business Plan. Most proposals are eliminated based upon a reading of the business plan. Without a good business plan it is difficult even to get a personal meeting with most VCs. The business plan is an important communication mechanism. It tells the VC why the business can make the investor a lot of money in a relatively short time span; it suggests how the investor can exit and what the venture will be worth at that point. The quality of the plan also tells the VC about the quality of management. Numerous works have been written about the effectiveness of business planning (Delmar & Shane forthcoming; Prince 1997). There are also many consultants who will help write a plan. Their quality varies vastly. The entrepreneur should remember, however, that he or she must really be the architect of the plan and must know, from top to bottom, what makes it tick—what its key assumptions are, where the risks and weaknesses lie, and what the key leverage points in the work are. Venture capitalists are apt to ask questions, such as “Where did you come up with the price points

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you used?” or “What will be the effect on earnings if a customer does not renew the contract?” The entrepreneur must know the business and financial models inside and out. Thus, the consultant’s role (if any) is to help develop the presentation, nothing more.

- **Be Prepared for the Meeting.** The initial meeting between the entrepreneur and VC is important. The entrepreneur should find out how the meeting will be structured. Usually such meetings are quite informal. However, the entrepreneur should be prepared to give about a 30-minute overview and have ready answers for the questions that the VC is likely to ask (Gladstone & Gladstone 2003). The entrepreneur must guard against becoming angry or defensive when asked tough questions and should remember that the VC is trying to assess both the value of the deal and the poise and honesty of the entrepreneur. The entrepreneur should also understand the main contingencies underlying the business plan, in case the VC questions the assumptions underlying the proposal.

- **Don’t (Over) Shop/Don’t (Over) Rely.** If the entrepreneur is dealing with only one VC for several months and the VC ultimately turns the deal down, the entrepreneur will have to start from scratch with another VC. Delays of this nature can be deadly for a thinly capitalized venture. In addition, a little competition between financial sources can improve the terms of the deal for the entrepreneur. Thus, the entrepreneur should try to develop more than one source of financing. However, this is a delicate matter. VCs don’t like to look at deals they think are being shopped around indiscriminately; they want to feel that they have a good chance of getting the deal if they like it. Otherwise, why should they spend a lot of time looking? If too many VCs have already seen and rejected the proposal, word will get around. On the other hand, if an entrepreneur relies only on one possible investor, he or she is subject to having very little bargaining leverage. Further, if the deal falls through with this investor and no other prospects have been contacted, the entrepreneur will have to re-start this lengthy prospect more desperate than before. The ideal is to let the venture capitalist know who else you will talk to and when. Some negotiation may occur around these issues.

- **Be Honest, but Sell.** The entrepreneur should be honest with potential investors. The relationship between the parties will only work if built on trust. If the VC does not trust the entrepreneur, he or she will not invest. In addition, the entrepreneur should not be excessively optimistic. Excessive optimism causes VCs to question the entrepreneur’s competence (Forbes 2005). On the other hand, the entrepreneur must remember that the objective is to persuade the VC to invest. VCs want to see that the entrepreneur understands the risks involved but is confident that they can be conquered. The entrepreneur should present the venture’s risk and uncontrollable factors honestly, and if possible, fairly early in the presentation, or at least, not as an afterthought. At the same time, if the entrepreneur cannot convince the VC of the venture’s potential and her own confidence and will, no money will be forthcoming.

- **Have Patience.** Generally the only thing that ever happens quickly in the venture capital process is rejection. Sometimes even rejection comes slowly. Actually securing and closing on an investment usually takes months of calendar time. The process involves out-of-pocket legal and travel expenses that can be significant for a new venture. Most importantly, the process takes a lot of management time. The entrepreneur must remember that she is asking for a ‘yes’ in a ‘no’ business. A rejection, and the feedback associated with it, should be used constructively when approaching another potential investor (Gladstone & Gladstone 2003).

### Get the Right Venture Capitalists

Given the potential contribution of VCs to the entrepreneurs’ success or failure, the entrepreneur should take steps to find the right VCs as investors, if he has a choice. Before spending time pursuing a specific VC firm, the entrepreneur should check to determine whether the firm is currently looking for new investments, the industries in which the firm will invest, their stage
preferences, and general track record. Other important dimensions should be considered. The foundations for a good match between VC and entrepreneur relate to complementary skills, a strong commitment, and the potential for the entrepreneur and VC to have an open, trusting relationship.

- **Complementary Skills.** Complementary skills mean that each party should have expertise that the other needs. The VC needs an entrepreneur that provides product and market expertise along with general management skills. The entrepreneur needs a VC who can add value beyond money (Sapienza 1992). In many cases, VCs specialize in certain type of ventures, e.g., in industry sectors or investment stages in which they have significant knowledge and expertise (Norton & Tennenbaum 1993). In addition, there are quality differences among VCs. Some VCs are simply better than others (Kaplan & Schoar 2005; MacMillan, Kulow, & Khoylian 1989). In short, entrepreneurs should know the specific competencies they are looking for in potential VCs. The importance of VC expertise for the entrepreneur is illustrated by the following quote from a Midwestern-based VC (De Clercq & Sapienza 2005):

> Our focus is very much oriented towards early-stage investments. Therefore, our people are specialized in providing support for seed stage investments. Since you have little information to make decisions and predict the future for this type of ventures, you also need to be a company builder. Therefore, we have built an expertise in helping early-stage firms to put together a top management team, or to find strategic partners.

- **Commitment.** Both parties need to be committed to the venture. An investment deal is structured to impose harsh penalties on the entrepreneur if commitment should waiver. On the other hand, while the VC’s capital is committed at the time of investment, the VC is not legally obligated to provide any value-added after the investment. Therefore, entrepreneurs should seek to deal with VCs who have a track record of staying committed to their ventures. During the height of the Internet investment boom, some VC firms began to assign their board seats to inexperienced associates in their firms, rather than to their more experienced general partners. Entrepreneurs complained that they were not getting the level of value added that the VC had promised (Wasserman 2003).

- **Trusting Relationships.** The entrepreneur should seek a VC with whom it is possible to develop an open, trusting long-term relationship. Ventures operate in complex and turbulent environments. When things do not go as expected, it is important that the pair can work constructively and efficiently together. Often important decisions have to be made swiftly and without verified facts, and there is no time to evaluate the other parties’ real motives or hidden agendas. Early development of trust is therefore important for both parties. It is particularly important to the entrepreneur since the VC will likely have the right to fire the entrepreneur if things do not go well. The entrepreneur should thus pick a VC with a history of fairness in performance evaluation (Sapienza & Korsgaard 1996). Referrals from colleague-entrepreneurs who have been funded by the VC in the past are useful in this regard.

In short, in the pre-investment stage both sides should seriously evaluate the other. VCs traditionally perform due diligence on the entrepreneur, yet many entrepreneurs do not perform extensive due diligence on the VC. Certainly the entrepreneur should pay attention to his or her own impressions of the VC. But these gut feelings are not sufficient. Entrepreneurs should talk about their potential VC with other entrepreneurs (both successful and unsuccessful) with whom the VC has invested.

### Obtain the Right Amount of Money

Venture capital, even for expansion and buyout stages, is an expensive form of financing. At seed and start-up stage, it is especially expensive—in that the amount of equity a venture must sell for a given level of investment—the ideal is to gain enough money to reach the next investment stage, taking into account the fact that needed time and money are both usually under-estimated.
The entrepreneur can usually proceed on the assumption that, if successful, he or she can raise more money later. This money can be raised at a lower cost if the venture has progressed well. This logic is what underlies the milestone financings discussed earlier. However, if the venture is not as successful as anticipated (i.e., if the entrepreneur has severely missed targets), the entrepreneur may enter into an even more expensive, distressed financing, or worse go out of business (Fried 2005).

In short, the entrepreneur must balance the risks associated with keeping more equity but running out of cash, against the risk of taking more cash than needed and selling a larger portion of the venture than was necessary. The ideal spot is somewhere in between, where the venture can meet its needs but the entrepreneur retains as much equity as possible.

Structure a Fair Deal

Deal structuring is often a major problem area, particularly in terms of valuation. In this regard the relationship between the two parties will always be somewhat adversarial since setting ownership percentages between entrepreneur and VC is largely a zero sum game. Early stage ventures are the most difficult ones to place a fair value on. Without tangible proofs like pilots or prototypes it is challenging to convince the VCs of the value of the business concept. Here, the best thing an entrepreneur can do is to try to use comparable ventures in the same or similar industry space at comparable rounds of funding as a price guide (Gladstone & Gladstone 2003).

Another common problem area in terms of deal structuring is that significant control is transferred from the entrepreneur to the VC. For the entrepreneur it is often difficult to accept, for example, that the VC has a right to dismiss the management of the venture or has a final say on the budget of the venture. Yet, board seats and certain oversight powers may be non-negotiables for many VCs. The entrepreneur needs to be educated in industry norms as well as VC-specific norms in order not to be blind-sided by such issues at the last minute.

Entrepreneurs should realize that, while their relationship with a VC is initiated during the pre-investment phase, the relationship continues through the post-investment phase to exit. This results in a dilemma at the pre-investment phase. On the one hand, during deal structuring negotiations the entrepreneur and VC are opposed to one another on major issues like valuation and control. On the other hand, once an investment deal has been agreed upon, the two parties become partners and have a mutual interest in co-operating openly with one another (Cable & Shane 1997). Therefore, both entrepreneur and VC have to be aware that the quality of their future relationship may be heavily damaged from overly aggressive negotiations in the pre-investment phase.

Post-Investment Phase

The post-investment phase of the relationship is the longest and most crucial phase. It is here that the VC can add or detract the most value. It is also in this phase that the VC may replace the entrepreneur. One study showed that 47 percent of CEO firings by VCs occurred when the CEO had good ideas, but was unable to execute them; 37 percent when the CEO and VC had major disagreements regarding what was best for the company; and 16 percent when the CEO took actions in his or her own self-interest, knowing that they were not in the venture’s best interest (Bruton, Fried, & Hisrich 2000). Experienced CEOs recognize that if VCs do take actions to put someone else in the role of CEO it is done with the belief that such action will bring higher value to the venture. Indeed, founder-CEOs often exit after completion of product development to make way for someone with a broader skill set (Wasserman 2003). Still, this move is significant and not to be taken lightly. In many cases, entrepreneurs actually feel relieved when they are replaced. Yet, although they may know in their hearts that they are in over their heads, few can willingly leave the helm unless forced. On the other hand, many times it is far from clear that the CEO should be changed. There are a variety of things the entrepreneur can do to minimize the risk of being fired and at the same time maximize the positive impact of the VC’s value-added activities.
Respect the VC

The entrepreneur needs to respect the expertise and experience of the VC. Yet the entrepreneur must recognize that the VC is not just a friendly advisor. The VC has significant formal legal power (Cable & Shane 1997). VCs are frequently in control of the board. If they are not, they usually possess contractual rights that will place them in control if the venture fails to meet expectations. However, the VC’s formal legal power is generally not absolute. The entrepreneur also has some formal legal power through rights as a corporate officer/employee and shareholder. Indeed, a common board structure is a five-member board consisting of two VCs, two entrepreneurs, and an unaffiliated third party acceptable to both. Because the use of formal power is highly confrontational, most VCs prefer not to use it. However, the shadow of the VC’s formal power always looms over the relationship.

Monetary power is also frequently present, particularly with staged investing. Any time the venture needs more money, those who can provide it have power—much like the aphorism, “He who has the gold makes the rules.” The VC’s money power is strongest when the performance of the venture is poor. On the other hand, good performance will increase the availability of funds from other sources.

After an investment is made, the VC retains the discretion to put in value-adding effort or not. Since a major benefit of the relationship to the venture is the VC’s value-added contributions, it is important that the VC spends adequate time providing these contributions. However, the VC has a limited amount of time to allocate among multiple companies. The VC may be tempted to allocate time in a manner that maximizes the value of his or her overall portfolio rather than the value of any one investment (Gifford 1997). Therefore, the entrepreneur must continually convince the VC that attention devoted to his or her venture is time well-spent.

Respect Yourself

The entrepreneur also has sources of formal and informal power (Fried & Hisrich 1995). The entrepreneur has power because he or she possesses important information that the VC does not. As the VC is involved in multiple firms in an assortment of businesses, the entrepreneur will have superior knowledge of the venture’s product and market. Particularly important is the power stemming from the entrepreneur’s operational control. While the VC may have a significant amount of formal power, this power is present at the shareholder and board level. From a practical standpoint, operational control is in the hands of management. It is impossible for the VC to dictate management’s every move (Cable & Shane 1997). Thus the VC routinely defers to the views of the entrepreneur who is responsible for day-to-day operations of the venture. As a result, there is room for an entrepreneur to exhibit passive, and at times active, aggressiveness and recalcitrance in the exercise of operational control. Yet, defiance to prove a point rather than to achieve a strategic objective will lead entrepreneurs to hollow victories. To maximize the value of the relationship between entrepreneur and VC and to avoid harsh conflict, it is important that the entrepreneur does not misuse power.

Communicate

In order to maximize the value of the relationship, good communication between the two parties is also mandatory. Communications should be regular and should include a mix of formal communication (e.g., the CEO’s report to the Board of Directors) and informal communication (e.g., through phone calls, social lunches, etc.) (Gladstone & Gladstone 2003). Good communication does not necessarily mean incessant communication. Asking about trivial matters and conferring on non-essential issues may undermine the VC’s confidence in the entrepreneur and reduce interest in further communications. In general, good social relationships between the two parties can play a positive role in enhancing the quality of communication, as illustrated by a Midwest-based VC (De Clercq 2002):
different things when there is a strong social relationship? We are more open, I would say. We don’t have to say things in a diplomatic way, we can talk to the other in a very blunt way. We can say the same things in a different way because you are close to each other. For instance, we can pick up the phone any time we want, or even can call them at home.

Be Trustworthy

Mutual trust is vital to any successful relationship. All through the post-investment stage there is the potential for opportunistic behavior by the entrepreneur (Cable & Shane 1997). The entrepreneur may take actions that actually hurt the venture, e.g., hiring an unqualified relative, padding expense accounts, or even plotting to “steal” the venture’s technology and customers and take them to another company. Clearly the entrepreneur should be scrupulous to avoid even the appearance of this sort of behavior.

More subtly, VCs are concerned when entrepreneurs use their operational control of the venture to hide negative information from the VC. One way to build trust is the use of fair procedures in the relationship. The relationship between venture capitalists and entrepreneurs is intense and is embedded in a context of great uncertainty. If nothing else, the two parties need to be able to believe in their partners’ fairness and goodwill. Research has shown that both parties respond powerfully to perceptions of their partners’ fairness. In one study it was shown that venture capitalists were more inclined to support entrepreneurs’ plans, to trust them, and to re-invest in their ventures (even if short-term performance was lower) when the entrepreneurs did what was procedurally expected and kept them well-informed. Another study showed that entrepreneurs, for their part, were more inclined to listen to what venture capitalists said and to be receptive to their influence when the venture capitalists treated them fairly (Sapienza & Korsgaard 1996; Busenitz, Moesel, Fiet, & Barney 1997). These potent effects are understandable in this volatile context, where much is out of the control of the partners. Both sides appear to respond strongly to actions that engender or undermine the sense of fair play.

Remain as Objective as Possible

While mutual trust is usually beneficial, both entrepreneur and VC need to remain objective about the other. When the two parties have a very high level of confidence in each other’s honesty and competence, there is a danger that they will not scrutinize the other’s decisions. As a result, the quality of decisions can be compromised (De Clercq & Sapienza 2005). Therefore, entrepreneurs should maintain a level of skepticism in their analyses of the VCs’ actions and input.

Exit Phase

To a great extent, a successful exit is caused by the entrepreneur and VC having built and maintained a good relationship in the foregoing pre-investment and post-investment phases. However, there are two important issues specific to the exit phase: avoiding a pre-mature exit and exiting harmoniously.

Avoid Premature Exit

Liquidation is obviously an unpleasant event. Yet it happens frequently among early-stage venture investments. Until the venture reaches positive cash flow, the venture is somewhat at the mercy of the VC. When the VC chooses not to re-invest, the venture can run out of cash and be forced to liquidate. The entrepreneur almost always wants to avoid liquidation, as liquidation means a loss of job, face, and the potential for large financial rewards in the near future. Still, the VC will not want to spend more time and money on a venture with little upside potential.

The entrepreneur should guard against the VC pulling the plug too early. The better the relationship in the post-investment phase, the less likely this is to happen. VCs tend to be more patient with under-performing ventures when they have a good, honest relationship with the entrepreneur. Yet there are clear economic limits to this patience.

The entrepreneur can also protect against premature liquidation by developing other funding sources. Then, if the VC does not want to proceed, the venture has a fallback position. However, the entrepreneur must also consider whether
a VC who does not want to invest more money may be completely right. In fact, historically the VC industry has erred by not pulling the plug fast enough on underperforming ventures (Guler 2003). Indeed, if the future of the current venture is bleak at best, it may even be in the entrepreneur’s own best interest to quit.

A less common form of early exit is VC “grandstanding” (Gompers 1996). Less experienced or less reputable VCs may seek to create an IPO exit route early on in order to enhance their own reputation. Similarly, a VC may jump at a profitable trade sale to show some positive returns in his or her current fund. These “grandstanding” VCs are less concerned about the optimization of exit timing from a valuation perspective, and more concerned about the effects the exit has on marketing their own services. The entrepreneur generally has the power to prevent grandstanding. Unlike liquidation, grandstanding is an issue for successful rather than unsuccessful ventures; greater venture success gives entrepreneurs more power to withstand potential grandstanding by their investors.

Exit Harmoniously

An exit event is a given in the entrepreneur-VC relationship. From the beginning of the relationship, an important goal of the VC is to exit the investment in a manner that maximizes the return on the investment. Entrepreneurs unwilling to accept the legitimacy of that goal should not seek VC financing. Exit should be a harmonious event that is primarily driven by the performance of the company and the capital markets.

Even in the case of liquidation, the relationship between entrepreneur and VC should be terminated harmoniously. Liquidation is the harsh reality of the venture capital world. Neither VC nor entrepreneur benefits from acrimony at this stage. It is best for both parties to learn from what went wrong, to increase their chances to be successful in a future venture.

In more pleasant types of exit, the VC plays a major role. Rarely does an entrepreneur approach the VC’s level of experience in exit transactions. For instance, seasoned VCs tend to bring their portfolio firms public when the market valuation is high (Lerner 1994). In addition, having well-known VCs as investors enhances the ventures’ image in the public stock market (Meggison & Weiss 1991). Given their experience in exit transactions and strong networks in the investment banking world, the entrepreneur should expect a high level of value added by the VC in the exit phase.

CONCLUSION

This article provided an overview of the dynamics in entrepreneur-VC relationships, focusing on different aspects of the relationship that are relevant to the acquisition and effective utilization of risk capital. The article was primarily written to provide aspiring entrepreneurs with more insights into how better to manage their relationship with venture capital providers. We conclude that the life of both entrepreneur and VC is fraught with peril but can bring great rewards, both financial and non-financial. For many VCs and entrepreneurs, their mutual relationship itself is a significant non-financial reward, no matter what the financial outcome. Even for those who do not enjoy the journey, maximizing the entrepreneur-VC relationship is important since it increases the chances of the entrepreneur’s venture ultimately being successful.

References


Fried, V. H., & Hisrich, R. 1995. The venture capitalist: A relationship investor. *California Management Review*, 37(2): 101–113. It should be noted here that BAs and CVCs are less likely to hold such powers.


ARTICLE 2

MULTIPLE CASE STUDY OF ENTREPRENEUR’S VENTURE CAPITAL INVESTOR SELECTION PROCESS

Earlier version of the paper was presented in EURAM 2007 conference.

Oskari Lehtonen
Multiple Case Study of Entrepreneur’s Venture Capital Investor Selection Process

Abstract

In this multiple case study I have analyzed entrepreneurs’ venture capital selection process. Venture capitalists’ selection criteria have been extensively studied before whereas entrepreneurs’ selection criteria have been overlooked. The analysis concentrates on two research questions: 1) what are the reasons that led to the selection of that particular VC or syndication of VCs? And 2) is there a positive association between entrepreneur’s pre-investment selection process and post-investment VC-entrepreneur relationship? In addition present a descriptive framework of entrepreneurs’ venture capital selection process.

INTRODUCTION

Venture capitalists (VCs) and entrepreneurs often form a close dyad and they have both conflicting and mutual interests. Entrepreneurs generally want to maintain control over their venture and as high ownership stake of the venture as possible. However, they need VCs to provide them funding so that they can develop their companies and make them grow. VCs in turn look for very high growth oriented firms. VCs acknowledge that not all entrepreneurs have a high tendency to growth and risk taking or that they lack some other capabilities that are needed from the entrepreneurs of high growth VC-backed ventures. Consequently, VCs analyse their investment candidates very thoroughly before making an investment decision (Macmillan et al., 1985). VCs’ selection criteria is very well documented in previous research and was among the first things that was of researchers’ interest when venture capital research became popular in the 1980’s (Wright et al., 2003). However, entrepreneurs’ position is considerably less studied (Arthurs & Busenitz, 2003). Especially ventures that try to acquire early stage funding may require additional resources rather than financial. It has been shown that VCs’ experience, image
and expertise vary. For example Ehrlich et al. (1994) have suggested that it is as important who the venture gets funding from as how much it gets. It has also been shown that it may not be in VCs’ interest to maximize the return on one particular venture but the entire portfolio of the firms (Gifford, 1997; Sahlman, 1990). Therefore, it may be that entrepreneurs do not get any or get very little value added from their investors. According to Fredriksen et al. (1997) VCs tend to put more of their time into portfolio firms that have problems. In short, the selection of a correct VC may have significant effect on what kind of and how much value entrepreneurs get from their investors. Finally, VCs commonly rearrange the management of their portfolio firms by dismissing the existing management. It could mean that the founding entrepreneurs are dismissed and they have to relinquish their ownership (Bruton et al., 1997). In sum, entrepreneurs have a lot at stake when selecting their investor but it has been very little studied.¹

In this multiple case study of four ventures I have analysed entrepreneurs’ selection process when they acquired VC funding. In order to organize the discussion I am, first, searching for answers to two research questions. First, as discussed above, the selection of VC investor may have important consequences on entrepreneurs’ business and it is, hence, a crucial decision for entrepreneurs. Therefore, it is important to understand what the reasons are that led to the selection of that particular VC or syndication of VCs. Second, it is beneficial for entrepreneurs to make as good a choice as possible while selecting a VC investor. It is not until in actual relationship that the entrepreneurs’ choice

¹ One isolated paper that has looked into this phenomenon in detail is Smith (2001). According to his study of 143 case companies, entrepreneurs prefer, in general, reputational and value-added contributions over high valuation but differences are minor. In addition, entrepreneurs’ geographical region, industry, experience and age provided significant variations to the results. In this study I will go further than just analyze entrepreneurs’ selection criteria by developing descriptive frameworks that could benefit both further research and practice.
is actually weighted and the entrepreneurs get or do not get value added from their VC investors. It is therefore important to understand how entrepreneurs’ selection ex ante influences the ex post relationship and, hence, I ask if there is a positive association between entrepreneur’s pre-investment selection process and post-investment VC-entrepreneur relationship. In addition, in this study I develop a descriptive framework that describes entrepreneurs’ VC selection process and finally I present selection criteria that entrepreneurs may utilize while selecting their VC investors.

The remaining of the article is organized as follows. In the second section I will discuss existing literature and develop my research questions. Then, in the third section I will discuss case methodology and data. In the fourth section I will present the case data and conduct analysis. The fifth section contains the discussion and concluding remarks.

**LITERATURE REVIEW AND RESEARCH QUESTIONS**

During the pre-investment phase VCs can be considered to be the more powerful parties of the relationship (Fried & Hisrich, 1995). They have power to decide whether they want to continue the discussion and eventually invest in the venture. VCs have commonly a broad selection of tempting business proposals that they can choose their investment candidates from (often referred to as deal flow). Entrepreneurs search for capital for some specific reason e.g. product development, commercialisation or internationalisation. The window of opportunity may close fast and, hence, entrepreneurs need to proceed rapidly with organizing funding. This supports the view that entrepreneurs have very little latitude in selecting their VCs and entrepreneurs should agree with one of the first VCs that is willing to invest in the venture (with realistic terms). In addition, it has been shown that VCs are highly networked and they constantly change information among each other
An entrepreneur that is “shopping around” may find it difficult to convince VCs after a while if the VCs have gotten some pre-information of the entrepreneur from other sources (De Clercq et al., 2006).

On the other hand, the better the venture is doing in terms of product development, pilots, demos, customers, reputation of the management and publicity the more attractive the venture becomes for VCs (Amit et al., 1990) and this may have an effect on the valuation and other terms of an investment agreement. Therefore, there could be an association between the quality of the venture and how carefully entrepreneurs select their VC investors.

Selection is also important due to the fact that VC investment negotiations can be long (lasting easily months) and expensive due to e.g. legal fees and management’s time that the project requires. Therefore, already the decision who to start negotiations with can be very important for the entrepreneurs due to time and resource requirements. It is important to note that, entrepreneurs may perceive their negotiation position differently than VCs, which could have an effect on the negotiation process. For example, entrepreneurs that have little or no experience on negotiation or interacting with VCs may have very unrealistic expectations on the value of their business or possibilities on acquiring VC funding.

As reported above, entrepreneurs may not be after only money from their VC investors, especially when a certain “quality threshold” has been crossed. Research has shown that entrepreneurs who enter into a relationship with VCs expect, in addition to financial benefits, nonfinancial contributions such as access to the VC’s networks, strategic planning, help to obtain additional funding and recruitment help (Gorman & Sahlman,
VCs’ and entrepreneurs’ bilateral needs and complementary resources provide a fruitful ground to utilize the resource based view. Its main suggestion is that a firm earns sustainable competitive advantage by obtaining correct critical resources, which are: valuable, rare, difficult to imitate and replace (Barney, 1991). A large number of studies have concentrated on this topic and especially from just founded, small and innovative ventures’ point-of-view. Similar type of firms also form the major portion of VCs’ portfolio firms (Dyer & Singh, 1998; Cooper, et al., 1991). Manigart, et al. (2002) used, among other frameworks, the resource based view in their five country study in VC context. They found that the less portfolio firms a VC investment manager had under his/her supervision the higher the required return and in addition specialized VCs had higher required return than unspecialised VCs. They concluded that VCs, therefore, believe that they create value (through advising etc.), which is consistent with the resource based view. Cornelius and Naqi (2002) tested resource based view by using data from Hong Kong and Singapore. Their research provided an unsurprising result: entrepreneurs’ resource strength is associated with low VC involvement and perceived resource weakness is associated with high VC involvement. However, all above-mentioned studies are conducted from VCs’ point of view and emphasis on entrepreneurs’ viewpoint has been overlooked.

In sum, extant literature provides various viewpoints that could help us understand entrepreneurs’ reasons for selection one particular VC. At least five different partially overlapping and contradicting viewpoints can be identified: First, entrepreneurs are in high need of financing and it is difficult to get. Therefore, entrepreneurs should choose the first VC that is willing to invest in them. Second, the better the entrepreneur’s quality
the better deal he/she might be able to negotiate and, therefore, it is important to discuss with various VCs before selecting one. Third, entrepreneurs are not often experienced in acquiring VC funding and, therefore, it is difficult to decide what is a good deal and what is a bad deal. Fourth, there exists information asymmetry that may make it costly or impossible for entrepreneurs to evaluate credibly the real quality of a VC investor and fifth, a VC can either provide substantial value added or be a destructive force for entrepreneurs and it is not easy to recognize which kind of VC you are negotiating with. 

In order to understand how case companies select their VC investors I will ask:

**Research question one:** What are the reasons that led to the selection of that particular VC or syndication of VCs?

The first research question relates to entrepreneurs’ behaviour and selection process during the pre-investment phase. However, at least equally important for the success of the venture is what happens when the VC and entrepreneurs have agreed on the investment and the co-operation between the partners begins. In other words are the partners able to conduct such high level synergetic co-operation between each other that it benefits the venture. For example in their evaluation process VCs often put considerable effort on characteristics of the management and chemistry between management and VCs. This should lead to improved chances of highly trustful cooperation (Cable & Shane, 1997). Considerable research effort has been devoted to explaining and conceptualising VCs’ and entrepreneurs’ relationship.

One of the most utilized theoretical frameworks explaining VCs’ and entrepreneurs relationship is agency theory. The theory models two actors: principal’s (i.e. a VC) and

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2 Other theoretical frameworks that have been utilized to explain entrepreneurs’ and VCs’ relationship are e.g. prisoners’ dilemma, procedural justice theory and stewardship theory (Wright et al., 2003).
agent’s (i.e. an entrepreneur) incentives and behaviour in a relationship that is characterized by information asymmetry, uncertainty and risk (Arthurs & Busenitz, 2003). Agency problems are often divided into two: adverse selection which exists prior to the beginning of the relationship (i.e. signing of the shareholder agreement) and moral hazard which is entrepreneur’s opportunistic behaviour after the relationship has already started (Arthurs & Busenitz, 2003). The concept of asymmetric information is used to explain the adverse selection. Asymmetric information makes it costly or even impossible for the principal to evaluate the agent’s ability and, therefore, a VC may invest in a less able entrepreneur (Akerlof, 1970). Moral hazard refers to the agent’s behaviour during the relationship that is not in the principal’s interest. The basic idea of agency theory seems applicable in VC-entrepreneur context and, therefore, it is no surprise that agency theory has been tested and at least partially shown to be applicable in many empirical studies (Sapienza & Gupta, 1994; Manigart et al., 2002; Reid, 1999; Van Osnabrugge, 2000). Reversed agency theory approach has been also getting some attention suggesting that also entrepreneurs can be seen as principals and VCs as agents. According to this approach it is in the entrepreneurs’ interest to evaluate in detail the quality of the VC investor ex ante and to protect itself against VCs’ moral hazard behaviour ex post (e.g. Repullo & Suarez, 2002). The relevant question is to what extent entrepreneurs’ pre-investment selection process influences the post-investment relationship? If entrepreneurs are, for example, able to improve the post-investment relationship by analysing in detail various VC investors (i.e. eliminating adverse selection) or by ensuring that the VCs’ incentives are aligned with those of the entrepreneurs (i.e. eliminating moral hazard) then this work is probably worth doing. Consequently I ask:
Research question two: Is there a positive association between entrepreneur’s pre-investment selection process and post-investment VC-entrepreneur relationship?

METHODOLOGY AND CASE SELECTION

I have utilized multiple case study approach in this study by selecting four companies that have acquired VC and corporate venture capital (CVC) funding from the U.S., the U.K, Germany, Sweden and Finland with various rounds of finance\(^3\). All the firms had their origins in Finland. Case study approach has been criticized for example due to low generalizability of the results, since the results are based on a few cases (Yin, 2003). However, Verschuren (2003) for example has stated that by using contrasting and overlapping cases the small number of cases can be compensated. Following his suggestion, I have utilized theoretical sampling method and have selected four partially contrasting and overlapping cases. Case Company A has gone into bankruptcy. It received funding once from one VC. Case Company B was eventually sold to another company. It acquired funding from several VCs during two rounds. Case Company C is a successful company and it is still operative. It received funding from several global VCs and corporate VCs during two rounds of financing. Case Company D acquired funding from one VC and was sold later with fairly good valuation to a U.S. based multinational company.

Case study research offers a variety of methodological tools that can be used to improve the quality of the research. I have utilized various data collection methods, interviews and focus group interview being the most important data collection sources\(^4\). Furthermore, I

\(^3\) In order to preserve anonymity I will use alphabets A, B, C and D to describe the firms.

\(^4\) I first interviewed entrepreneurs of case companies A, B and C separately and after that the entrepreneurs’ of those three ventures get together to a focus group interview. Case company D did not participate in the focus group interview and was interviewed later.
acquired background information from various sources. Background information included company reports, newspaper articles, press releases and other published material. The depth of the data made possible the usage of triangulation, which improves the reliability of the data (Eisenhardt, 1989). In addition, before approaching and interviewing the entrepreneurs I conducted a pilot interview in order to test the research method and structure. All interviewees were the lead entrepreneurs with profound information about their venture’s relationship with VCs. The interviews were recorded, transcribed and written down for analysis. I also contacted the interviewees after the interviews in order to clarify some unclear points, which I identified during the analysing phase. I first analysed the data by using within-case analysis and thereafter I broadened my approach to cross-case analysis (Eisenhardt, 1989).

As always in a case study research the question whether the informants actually provided correct information is relevant and justified. There is a risk that the informants, for example, provided “socially acceptable answers” or that e.g. the success or failure of their venture influenced their answers to my questions unintentionally. Fortunately, I had several methods that helped me to improve the internal validity of the data. First, I have a fairly long former career as an IT-entrepreneur myself and my inside knowledge of the business helped me to win the informants’ trust and I was able to have in detail and high quality discussions with all entrepreneurs. Second, neither the entrepreneurs’ identity nor their firm names are revealed in the study and, hence, they could provide their information with confidence. Third, I utilized additional material such as newspaper articles and company presentations as my background material when I prepared for the
enterviews and during the interviews. In that way I was able to ask relevant questions that consequently provided me relevant and accurate answers.

ENTREPRENEURS’ SELECTION PROCESS OF VENTURE CAPITALISTS – FOUR CASES

In this section I will present four cases of how entrepreneurs selected their venture capital partner and describe their post-investment relationship. The cases show considerable differences in the strategy of the entrepreneurs. First I will give a brief overview of all the cases (within-case analysis) and then I will compare the cases (cross-case analysis).

Presentation of four cases

Case Company A. The first venture developed mobile applications and software for telecom companies, media and other corporations. The company had managed to create considerable hype around itself and was, for example, mentioned in the New York Times and CNBC, which was not bad for a small Finnish start-up. The entrepreneurs were not experienced in acquiring VC funding but they had several interested investors who contacted them and the entrepreneurs were encouraged by many to rapid growth and, hence, they decided to acquire VC funding. They ended up getting involved with one U.K. based investor. The main reasons were, first, that the VC was well known in the industry of backing successful entrepreneurs and, second, because it provided respected industry reports and by becoming the VC’s portfolio company Case Company A could have broad access to those reports. In addition the entrepreneurs expected that an international VC would provide them international contacts and the chemistry with the VCs seemed to be good. The entrepreneurs did not conduct any analysis between different investor candidates. The search for VC was conducted using internal resources.
(the board members had experience in M&A activities) and many VCs contacted proactively the venture. The entrepreneurs did not analyse nonfinancial contributions that were needed by the venture and potentially could have been provided by VCs. The post-investment relationship with the VC was first really good but started to go sour when the IT-markets turned south. During the final months of the relationship VCs were difficult to get hold off and they did not even return call requests. The VC was responsible for organizing a new round of financing for the venture and during the process the VC rejected several low valuation offers since that would have lowered the valuation of the firm in the VC’s balance sheet. The entrepreneurs are of the opinion that due to the VC’s behaviour the venture went into bankruptcy or that with a more capable VC at least some parts of the venture could have been saved.

**Case Company B** had its origins in a technology university’s research project in Finland. It operated in a mobile payment and transaction business and had considerable difficulties in finding an investor. The entrepreneurs approached several Finnish VCs and the term sheets that they got (if they got anything) were, according to the entrepreneurs, very unreasonable and unfair. The entrepreneurs considered that the VCs demanded too extensive rights to determine and decide how the firm would be developed in the future but were willing to provide funding only for a short period of time. Accepting this kind of an offer would have been very risky for a firm that most likely needed additional funding before it turned cash flow positive. Before VC funding the venture financed its operations by using government grants and income financing. However, they did not cover expenses and the entrepreneurs needed additional capital fast. Eventually, the entrepreneurs were able to find a German CVC that was willing to invest in the venture. Due to the reason
that there were no substitutes the entrepreneurs did not really analyse any options or potential value added contributions that the VC was able to provide. The entrepreneurs just wanted the money before the firm was in insolvency. After the German CVC the venture acquired two rounds of finance led by one of the top VC firms from Silicon Valley. The entrepreneurs were mainly responsible for acquiring the additional venture capital, not the first round investor. Due to the downturn of IT and mobile sector in the beginning of the 21st century the venture was merged with another company from the U.S. and the founding entrepreneurs did not get a lot out from the deal. However, they do speak very highly of their investors (both German and U.S.). They praise their professionalism, skillfulness and the much needed encouragement, suggesting that the post-investment relationship was good even though the entrepreneurs did not make any major attempts to ensure that beforehand.

**Case Company C** was a start-up of an entrepreneur who had experienced a bankruptcy earlier in his career due to insolvency problems and who was, hence, extra careful with liquidity and financial planning. Before VC investment the venture developed internet, intranet and extranet solutions for firms but after the investment the venture concentrated on mobile phones’ operating systems.

The first round of funding fulfilled the long-term strategy of the venture but it took two years to materialize. During that time the entrepreneurs hired a consultant who helped to develop a story to VCs and organized meetings with them. The entrepreneurs met over 15 VCs both in Finland and internationally. However, they ended up with two Finnish investors; one CVC and a venture capitalist. Especially during the second round of finance, when the venture managed to acquire one of the biggest venture capital
investments ever acquired in Finland the entrepreneurs operated very strategically. During the search process that lasted 18 months they met, according to the lead entrepreneur, 72 VC firms and they had eight syndicates that were willing to invest in the venture. Among other things the entrepreneurs conducted a SWOT-analysis of all the syndicates and eventually decided to accept an investment from the syndicate that had the most famous corporate investors but at the same time the lowest valuation (meaning that the entrepreneurs’ ownership diluted more than in the other offers). The following quote from the entrepreneur illustrates their thinking:

“We already had Nokia as a major customer, therefore, we did not need them [Nokia’s corporate venturing unit] as an investor to increase our contacts in the organization. Instead we wanted to increase our sales in Ericsson [Nokia’s major rival from Sweden]. However, getting Ericsson to invest in us might have disturbed Nokia and, therefore, we wanted to use a more indirect strategy. With the help of our advisor we created a plan and approached one of Ericsson’s major shareholders Investor AB [major VC firm] and convinced them to invest in us. This solved all our problems. We still had Nokia as a happy customer but also we increased our contacts to Ericsson considerably and they had more incentive to co-operate with us.”

However, after the investment most of the issues that the entrepreneur and the investors had agreed on did not materialize. For example the venture had made initial agreements (the corporations were not willing to sign binding contracts) with the corporations that invested in the venture about future co-operation projects. When the markets turned south after the dot.com crash the corporations simply denied continuing the projects. These co-operation projects were, in addition to image-benefits, one of the most important criteria for the entrepreneurs for selecting these particular investors and, therefore, the VCs’ withdrawal from co-operation had a very big impact on the venture. A few years after the VC investment, the venture merged with a listed firm with fairly good valuation.
Case Company D had been delivering IT-solutions and consulting projects for one telecom company in Finland. When the markets turned after dot.com the venture soon discovered that its order backlog was decreasing very fast and the venture decided to revise its strategy towards mobile games. It was expected that it would take years before mobile games would provide enough revenue for the firm and, therefore, VC funding was needed. The firm recruited a new CEO who was responsible for acquiring funding. The CEO came from the financial sector but did not have experience in VC funding. It took approximately nine months to acquire funding and the entrepreneurs contacted a broad majority of technology investors in Finland and some investors in Sweden and the U.K. The VC that eventually invested in the venture was the only one that was willing to invest in the venture due to the risks that were involved in the totally new business area of Java based mobile games. The VC was located through the Case Company’s chairman’s contact network. Case Company D was the VC’s first technology investment.

Due to the very tight financial situation the entrepreneurs were willing to accept almost any kind of a deal that was suggested to them by the VCs. They did not analyse the expertise of the VCs or the complement resources of the partners. The entrepreneurs were purely interested in getting funding and, hence, accepted the deal that was offered as it was. It was clear from the beginning that the VC was going to be very hands off. However, the VC’s hands off strategy went very far. The VC often objected to changes that were needed in the highly turbulent mobile game business. This created disputes between the entrepreneurs and the VC and their relationship was sour. The venture was eventually sold with fairly good valuation to a very big IT-firm from U.S. The trade sale was organized by the entrepreneurs not the VC.
In table 1 I will present key descriptive facts of the Case Companies.

Cross-case analysis of data

In order to organize the discussion of entrepreneurs’ VC investor selection process I have derived two research questions: 1) What are the reasons that led to the selection of that particular VC or syndication of VCs? And 2) is there a positive association between entrepreneur’s pre-investment selection process and post-investment VC-entrepreneur relationship? Below I will conduct a cross-case analysis of the data regarding the research questions.

According to the data Case Companies B and D did not have any other realistic choice than either to go into bankruptcy or to accept the venture capital deal offered to them. However, Case Companies B and D had some time to search for capital and Case Company B actually received some term sheets that were rejected since they were considered unfair and bad. However, when Case Company B’s and D’s situation started to deteriorate and insolvency was looming even bad deals became more attractive. Luckily Case Company B managed to secure funding from a German VC. Case Company D contacted the majority of local (Finnish) VCs and some international VCs. Eventually one VC was willing to invest in Case Company D. Case Companies B and D were willing to accept any deal that prohibited them from going into bankruptcy. The role of nonfinancial value added was not important for these entrepreneurs. Their main reason that lead to the selection of their VC investor was to survive.
Case Companies A and C were in a position where they could have been selective in terms of their venture capital partner. Case Companies A and C had very different strategies. Case Company A mentioned some commonly known nonfinancial contributions of the VCs but without really being able to substantiate how these contributions would have benefited the venture. On the contrary Case Company C did a very thorough job in its analysing and strategy work in terms of its VC partner. The entrepreneurs of Case Company C put a lot of expectations to the complement resources of the venture and its investors. The entrepreneurs made a lot of effort to ensure that venture capitalists and particularly CVCs would also deliver the discussed issues by drafting non-binding letter of intents with the corporate arms and relevant business units of the corporations that they were negotiating with. In addition, the entrepreneurs of Case Company C wrote separate business plans with each CVCs that were included in the investment agreements. They were willing to accept the lowest valuation offer of the competing syndicates in order to have the possibility to do co-operation with these particular venture capitalists and CVCs that had the most to offer in terms of nonfinancial contributions. Another interesting fact is that Case Company A emphasized more the chemistry between the VC and entrepreneurs while the entrepreneur of Case Company C acknowledged the fact that the persons would be changing constantly in these organizations and, hence, emphasis on chemistry was not to them that relevant. On the contrary, Case Company A did not make any specific attempts to ensure that their venture capital partner would deliver any nonfinancial contributions nor did they analyse in detail what those critical resources that were needed would be. In sum, Case

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5 A similar phenomenon was identified in Hsu (2003) where 57% of entrepreneurs, that received multiple VC offers selected a lower valuation offer due to (an investing) VCs’ higher reputation.
Companies A and C had the option to be selective in their venture capital partner selection but only Case Company C really utilized this possibility. Case Company A selected a VC that was available with the least amount of work and that “felt good”.

Regarding the second research question of association between post-investment relationship and pre-investment selection process, Case Company A mentioned the importance of chemistry as a selection criterion of a VC. However, when things started to go bad the chemistry was very fast deteriorating and the entrepreneur even blames that it was at least partially the VC’s fault that the venture went into bankruptcy. In Case Company B the entrepreneurs did not have eventually any other options than to accept funding from their VC. However, they had met earlier when their financial situation was not that bad several other VCs that they had considered unreasonable and unfair and they had turned those offers down. According to their view the VC that eventually invested into their firm during the first round was considered fair and acknowledgeable in the venture’s business sector. Also the chemistry during post-investment phase was considered very good even though the venture did not really succeed and was merged with another company with low valuation. In sum, Case Company B’s post-investment relationship was positive and co-operative regardless of the lack of in-depth analysis before committing into the relationship. As reported above Case Company C made very extensive efforts to ensure that it would have a positive and beneficial post-investment relationship with its investors. However, this did not happen and most of the benefits that were expected did not materialize due to the fact that investors withdrew from non-binding agreements due to market turn. In addition, Case Company C reported some nonfinancial value added contributions that their VCs and CVCs provided such as
international sales and networking events but they were far less that what the entrepreneurs expected from the relationship. Case Company D did not take any specific actions to ensure a good post-investment relationship and their relationship was negative with their VC. In sum, according to my data there is no positive association between entrepreneurs’ pre-investment selection process and post-investment VC-entrepreneurship relationship. In table 2 I sum up the two research questions and the data.

DISCUSSION

In this study I have examined how entrepreneurs selected their venture capitalists and whether it had influence on their post-investment relationship. My data consists of four ventures that have all received at least once venture capital funding. I have analysed the data using case study methods such as with-in and cross-case analysis. The data has been collected through interviews, focus group interview and by collecting additional material such as press releases, company reports and news articles.

When the results of this study are interpreted it is important to acknowledge some limitations. First, the analysis is based on only four case companies. For example Smith (2001), who has published an isolated paper of entrepreneurs’ selection process, showed that entrepreneurs’ selection criteria may vary according to entrepreneurs’ geographical region, industry, experience and age. My analysis of four cases cannot capture these kinds of variations. Second, my data was collected after the dot.com bubble had exploded and all my case companies had interacted with their investors during the dot.com boom.
That time period can be considered extraordinary in terms of VC financing and may have also influenced the results.

Keeping these limitations in mind, according to the data, even the entrepreneurs who have the possibility to be selective with their equity partner do not always use the possibility. Two of my case ventures could have been selective and demanding but only one fully utilized its strong negotiation position (Case Company C). The reasons for this could be diverse. For example, the entrepreneurs just do not have time to analyse in detail the various VC candidates. Entrepreneurs do not necessarily have a very tight financial situation but they have the business to run and, therefore, they do not have time to invest in detail analysis if an adequate VC partner is already available. Second, they do not necessarily have the competence to really compare what VCs could actually provide them. It is easier to compare valuation, money and terms that VCs are offering than more intangible nonfinancial contributions. The evaluation is also characterized by a similar but reversed phenomenon that VCs encounter while they analyse entrepreneurs: It is difficult to evaluate the accuracy of the information that VCs provide for entrepreneurs. In other words, the asymmetric information problem that VCs are commonly worried about exists for entrepreneurs as well (Amit et al., 1990). Third, entrepreneurs are often not very experienced in acquiring VC funding and, therefore, they do not necessarily understand and know what kind of benefits VCs can actually provide them during the relationship. This makes in detail analysis and comparison of VCs very difficult for entrepreneurs. All the above mentioned three reasons can be attached to Case Company A. Case Company C acknowledged its lack of experience of acquiring VC funding and hired an outside advisor. The advisor helped the entrepreneurs to select an optimal
partner. In their case it meant lowest valuation and the potentially best nonfinancial contributions. In figure 1 I have illustrated the selection process of how entrepreneurs select their VC investors. The key components are: 1) quality of the venture perceived by entrepreneurs, 2) entrepreneurs’ experience and skills in negotiating with VCs and 3) needed nonfinancial contributions. Entrepreneurs that perceive that their venture’s quality is not high either accept any VC deal or start searching for alternative financing methods (Case Companies B and D). Depending on the skill and experience level of the entrepreneurs they can either accept almost any deal offered by a VC (low skill and experience level of entrepreneurs, e.g. case A) or they can analyse in detail the best possible match between VC and entrepreneur (Case Company C with help of advisors).

One characteristic that is especially discouraging for entrepreneurs is Case Company C’s relationship with its investors. The entrepreneurs put considerable effort to ensuring that they would get substantial benefits from their VC investors during post-investment phase. They accepted the lowest valuation deal offer by VC syndicates. They wrote separate business plans with all CVCs that took part in the investment syndicate (all of them are Fortune 500 companies). Soon after the investment IT-markets turned south and all the CVC firms withdrew from their commitments. This created a very difficult situation for the venture. It had selected the best possible investment syndicate for its needs but by withdrawing from their commitments the CVCs suddenly changed the situation. By accepting a higher valuation deal from other syndicates the venture might have done better than by trusting the non-binding contracts of the CVCs. In other words, even by
doing everything that Case Company C could it was not able to ensure that the post-investment relationship was co-operative and positive and that the firm got out of it the nonfinancial contributions that it expected.

Similarly as Case Company C, also Case Company A highlighted the importance of changes in external environment. When markets changed their VC became very difficult to get hold of and, according to the entrepreneur, the VC also failed to organize additional funding as was agreed. In other words, while previous examinations of the relationship between VCs and entrepreneurs have concentrated on the dyad (Sapienza & Gupta, 1994) it may be beneficial to extend the examination to external factors such as operating environment as well since it has, according to my data, profound effects to the relationship as well.

Case Company B had a really positive and co-operative relationship with its VCs. That relationship was agreed on without very in depth analysis between the partners. The entrepreneurs were in a very difficult situation. They needed funding fast and only one particular VC was willing to provide it. The same VC, however, also understood the value proposition and business of the venture very well. The entrepreneurs maintained a good and co-operative relationship with both the German CVC (lead investor of 1st round) and the U.S. VC (Lead investor of 2nd and 3rd round) even though the venture was not a major success. Presently the entrepreneurs and the founders have resigned from the firm due to strategy change related to merger of Case Company B and an U.S. firm.

According to Case Companies there was very little concretive nonfinancial contributions that VCs provided to entrepreneurs. I also identified problems that entrepreneurs can end-up in by acquiring venture capital funding. Case Company A’s VCs agreed that they
would organize the next round of financing but failed to do so. This lead to the
bankruptcy of Case Company A. Case Company B’s founders resigned from the venture.
Case Company C did not get the nonfinancial contributions it expected and Case
Company D had problems with its VC that wanted to slow down the venture’s
development. However, sometimes there are no other funding options as in cases B and
D⁶. Nevertheless, Case Company D did eventually well in financial terms and managed
to sell the venture with good valuation to a big U.S. IT-firm. In sum, based on my data of
four cases, it appears that by making a random choice entrepreneurs could be in as good a
situation as by carefully analysing their options: a company that put considerable effort to
ensuring beneficial and positive post-investment relationship did not succeed (Case C)
and Case B reported a beneficial relationship but without making those investments. On
the other hand cases C and D did the best in terms of cashing out especially for
entrepreneurs⁷. This rather surprising result that there is no associating between
entrepreneurs’ pre-investment analysis and post-investment relationship could be a result
of the small sample of only four firms and needs certainly further research.

My research provides important insights for venture capitalists, entrepreneurs and
academics. First, VCs that compete with other VCs for the best deals may improve their
chances of getting the deal by clearly communicating the potential nonfinancial
contributions that they would be able to provide to the venture⁸. The due diligence

⁶ To illustrate how limited the possibilities are for entrepreneurs to acquire other than VC funding is Fried
and Hisrich’s (1994) case study where none of the 18 case firms was able to name alternative funding than
VC funding.
⁷ Case company C’s second round investment was conducted during peak of dot.com boom and even
though the entrepreneurs did not accept the highest valuation offer they still got very high valuation for
their firm. However, when the venture merged with a stock listed company the entrepreneurs would have
probably benefited more by accepting a higher valuation offer than the offer that they accepted.
⁸ This “money chasing deals” thinking has attracted attention lately when inflows to VC funds has
increased more than good investment candidates (Gompers & Lerner, 2000).
process that precedes VC investment could reveal the best targets for utilization of the VC’s nonfinancial contributions and by correctly communicating them the VC might be able to convince the entrepreneurs to give away more equity (as did the entrepreneurs in case C) in order to acquire those nonfinancial contributions. Secondly, Case Company B’s experience of very low valuation and unfair investment proposals raises several questions: Do VCs truly believe that entrepreneurs would be willing to agree on those terms and how motivated would the entrepreneurs be after being made to accept such terms? Furthermore, how does this kind of behaviour by VCs to benefit from entrepreneurs’ bad financial situation reflect the VC’s image that has been suggested to have profound effects on the future deal flow and return on VC funds (Denis, 2004)? One explanation for the VCs’ behaviour could be that VC markets and VCs’ operating procedures were not well developed when my Case Companies negotiated financing and market conditions were extraordinary as noted above. Thirdly, my research project draws attention to the fact that two of the four case companies said that they contacted almost all technology investors in Finland (Case Companies B and D). These contacts wasted a lot of resources from both VCs’ and entrepreneurs’. Therefore, more in detail and specific guidelines of what kind of deals VCs are looking for might be appropriate and could limit unnecessary contacts.

For entrepreneurs, my research suggests more in detail analysis of, first, needed nonfinancial contributions and then matching it with potential nonfinancial contributions of VCs. However, according to my data, the strategy of going with the VC that provides the highest valuation may not be such a bad strategy either. Secondly, entrepreneurs that lack experience in VC funding may benefit from specialized advisor firms that help
entrepreneurs to acquire VC funding. Case Company C did hire an advisor firm that helped them to select the best possible VC investors ex ante. After the investment event investors withdrew from their commitments and most of the nonfinancial contributions that Case Company C expected did not materialize. However, it is likely that without advisors Case Company C could not have developed such an elaborate plan that it now did. In order to assist entrepreneurs to select VC investors I present, in table 3, a list of entrepreneurs’ investor selection criteria. The list is adapted from Sapienza et al.’ work (1996). I have separated funding from the strategic role as it was originally presented. In addition, I have included image benefit as a separate selection criteria. It has been shown to have a significant impact on entrepreneurs’ selection criteria both in my study (especially case company C) and in previous research (Hsu, 2003). In table I also report how relevant the Case Companies considered these selection criteria before they made their selection of a VC investor.

From academic point of view, this study answers the call made by Arthurs and Busenitz (2003) that more research of VC funding process is needed from entrepreneurs’ point of view. According to my data, it is clear that entrepreneurs need more help when assessing the applicability of their venture capital partner. The framework that I presented in figure one and descriptive list of issues that entrepreneurs may want to consider before selecting their equity partner in table 3 could offer approaches into more in detail research of the entrepreneurs’ VC partner selection process. However, the phenomenon needs a lot more research. For example, I excluded from my framework the element of high vs. low
valuation offers promoted by VCs. In other words a VC that is suggesting a high valuation deal may compensate its lack of nonfinancial contributions in the eyes of the entrepreneurs. On the other hand even very high valuation offers cannot compensate the fact that some VCs are more likely to dismiss entrepreneurs after they have invested in their firms. Entrepreneurs’ dismissal may mean that they also have to relinquish their ownership with very low valuation.

As noted, academic research of VCs’ decision-making has been conducted for more than two decades and the key decision criteria of VCs have been identified (see e.g. Macmillan et al., 1985). For entrepreneurs that is not the case and only one isolated paper by Smith (2001) has touched upon this important subject. In addition, Hsu (2003) has shown that VCs’ high reputation has an influence on entrepreneurs’ selection process. According to my data (and especially Case Company C) another aspect such as potential future co-operation was a decisive selection criterion for those entrepreneurs. However, based on my data entrepreneurs are not always competent to evaluate what kind of nonfinancial contributions they might need and could potentially get from VCs (e.g. Case Company A). Another very interesting question is how entrepreneurs’ in detail pre-investment analysis will influence the post-investment relationship. According to my data there is no positive association between entrepreneurs’ pre-investment analysis and post-investment relationship, which is rather surprising. Based on this descriptive case study article it seems that future empirical work among entrepreneurs’ VC selection process is well needed and could provide substantial benefits for practitioners and interesting research avenues for academics.
REFERENCES


<table>
<thead>
<tr>
<th></th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
<th>Case D</th>
</tr>
</thead>
<tbody>
<tr>
<td>How many VC’s were met during</td>
<td>Over dozen</td>
<td>10-20 VCs (first round), second round VC contacted entrepreneurs</td>
<td>First round approximately 15 and 72 during second round</td>
<td>Approximately 30. All technology VCs in Finland and some VCs from Sweden and the U.K.</td>
</tr>
<tr>
<td>the search process?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>How long it took to organize</td>
<td>Over six months</td>
<td>Six months</td>
<td>First round two years and second round 18 months.</td>
<td>Nine months but only weeks when a VC that was willing to invest was eventually found.</td>
</tr>
<tr>
<td>funding?</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Did entrepreneurs use any</td>
<td>Lawyers</td>
<td>Lawyers</td>
<td>First round a consultant who helped to develop “a story” and organized meetings. Second round a specialized advisor firm from U.S. In addition lawyers.</td>
<td>Lawyers</td>
</tr>
<tr>
<td>outside advisors?</td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tbody>
</table>
# Table 2
Summary of research questions and data

<table>
<thead>
<tr>
<th>Research question one: What are the reasons that led to the selection of that particular VC or syndication of VCs?</th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
<th>Case D</th>
</tr>
</thead>
<tbody>
<tr>
<td>VC was easy to locate (it approached entrepreneurs) and it felt right. In detail analysis about VC was not conducted.</td>
<td>After long search period the venture was in bad financial situation and to avoid bankruptcy entrepreneurs were willing to accept almost any deal that was offered them.</td>
<td>Entrepreneurs did very deep analysis of the VCs before it accepted VC’s offer. Entrepreneurs, for example, estimated that nonfinancial contributions were more valuable than higher valuation and accepted offer from syndication with lower valuation but better nonfinancial contribution potential. In addition, entrepreneurs respected high reputation of CVCs (all of them were Fortune-500 companies).</td>
<td>Venture contacted almost all Finnish VCs and all of them turned entrepreneurs down. When one VC eventually showed interest to invest in the venture entrepreneurs were willing to accept VC’s investment proposition as it was.</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Research question two: Is there a positive association between entrepreneur’s pre-investment selection process and post-investment VC-entrepreneur relationship?</th>
<th>Case A</th>
<th>Case B</th>
<th>Case C</th>
<th>Case D</th>
</tr>
</thead>
<tbody>
<tr>
<td>Entrepreneurs made only very modest attempts to ensure post-investment relationship except that they emphasized chemistry. When markets turned after dot.com boom the relationship turned sour very fast and positive chemistry disappeared.</td>
<td>Entrepreneurs did not make any specific actions during selection process to ensure good post-investment relationship but still the relationship was positive and co-operative.</td>
<td>Entrepreneurs made a lot of effort to ensure profitable post-investment relationship by taking pre-investment selection process very seriously but still the post-investment relationship was not as good as entrepreneurs expected.</td>
<td>Entrepreneurs did not make any attempts to ensure beneficial post-investment relationship. The relationship was weak or negative.</td>
<td></td>
</tr>
</tbody>
</table>
Figure 1
Entrepreneur’s selection and decision process

Quality of the venture perceived by entrepreneurs

Skill / experience acquiring VC funding

Nonfinancial needs

Any deal that a VC suggests or alternative funding

Any deal that a VC suggests

High complementary resources
### Table 3
Entrepreneurs’ venture capitalist selection criteria

<table>
<thead>
<tr>
<th>Decision criteria</th>
<th>Explanation</th>
<th>Relevance to the data</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Strategic value added</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sounding board</td>
<td>Listens, responds objectively, frankly, and truthfully</td>
<td>None of the case companies reported this relevant</td>
</tr>
<tr>
<td>Business Advisor</td>
<td>Discusses plans, reviews targets, offers feedback, provides management assistance and notes threats</td>
<td>None of the case companies reported this relevant</td>
</tr>
<tr>
<td><strong>Interpersonal value added</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Mentor/coach</td>
<td>Provides encouragement, positive reinforcement, support, and motivation</td>
<td>Chemistry was considered important by Case Company A</td>
</tr>
<tr>
<td>Friend/confident</td>
<td>Is concerned for (CEO), will go out of his way for (CEO), listens to (CEO's) problems</td>
<td>Chemistry was considered important by Case Company A</td>
</tr>
<tr>
<td><strong>Networking value added</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Source of professional contacts</td>
<td>Knows or can locate CPAs, lawyers, et al.</td>
<td>Case Companies A and C considered this important</td>
</tr>
<tr>
<td>Source of industry contacts</td>
<td>Helps generate orders, reach licensing or lease agreement, locate key suppliers etc.</td>
<td>Case Company A and especially C considered this important</td>
</tr>
<tr>
<td>Management recruiter</td>
<td>Helps locate key members for the management team</td>
<td>None of the case companies reported this relevant</td>
</tr>
<tr>
<td><strong>Funding value added</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Timely funding</td>
<td>Provides funding with reasonable terms</td>
<td>Funding was reported very important for Case Companies B and D.</td>
</tr>
<tr>
<td>Follow-up funding</td>
<td>Is willing to provide additional funding (if milestones are met)</td>
<td>None of the case companies reported this relevant</td>
</tr>
<tr>
<td><strong>Image value added</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Image</td>
<td>VC is well-know among relevant stakeholders and is likely to increase entrepreneurs reputation</td>
<td>Case Company C considered this very important</td>
</tr>
</tbody>
</table>
ARTICLE 3

POWER BETWEEN ENTREPRENEURS AND INVESTORS: A CASE STUDY


Oskari Lehtonen
Power Between Entrepreneurs and Investors: 
A Case Study‡

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Swedish School of Economics and 
Business Administration

Introduction

Two main approaches have been utilized to explain the relationship between entrepreneurs and their investors. The first is based on the separation of ownership and management i.e. the so-called principal-agent approach. The second emphasizes trust and cooperation in the relationship. This article offers new perspectives from which to analyze the relationship by utilizing power constructs such as dependency, power balance/imbalance and different power sources in the setting. The data are based on the author’s eighteen month period of observation as a business angel in one entrepreneurial venture.

The relationship between entrepreneurs and their equity investors (professional venture capital firms and wealthy individuals known as business angels) has attracted considerable research attention in the last twenty years (see e.g. Denis (2004); Wright and Robbie (1998)). It has been suggested that a co-operative relationship is an important precondition of the successful development of a venture (Cable and Shane (1997)). Extensive research has thus been devoted to increasing our understanding of the characteristics and conditions of co-operative relationships. From the investors’ point of view, it is essential to invest in entrepreneurs who are the most likely to increase the valuation of the venture and eventually provide investors with an exit that is several times the initial investment (Macmillan et al.

‡ I wish to express my gratitude to Dr. Marjo-Riitta Parzefall for her comments and encouragement in earlier versions of this paper. In addition, I would like to thank the participants of the 17th AOEF conference in Pasadena L.A. and one anonymous referee for their valuable comments. Last but not least, my thanks go to the two entrepreneurs with whom I spent almost two years working on the project. Unfortunately, the business venture did not succeed but hopefully we can all learn from the project, both in an academic and practical sense. All errors and inconsistencies are mine.

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Entrepreneurs often seek not only capital from investors but also nonfinancial benefits, such as strategy consultation, access to networks and mental support, which can be equally important to their success (Sapienza et al. (1996)). Despite all efforts, the entrepreneurs’ and investors’ relationship is not, however, always successful and co-operative. Several reasons have been identified that have influenced the relationship such as asymmetric information, lack of trust, parties’ opportunistic behavior and change in motivation i.e. one party decides to proceed with another project (Cable and Shane (1997)). Investors’ detailed pre-investment analysis, efficient contracting and active post-investment communication are methods that are utilized to reduce these problems but are not always successful (Sahlman and Stevenson (1985)). Some authors have suggested that also entrepreneurs should analyze their investors in detail prior to the investment decision (Ehrlich et al. (1994)).

In this article, I shall examine power, which has previously been largely overlooked in this context, as a “theoretical tool” for understanding and explaining the relationship between entrepreneurs and their investors. Power has a very long history in organizational research and scholars such as Marx and Engels and Weber have already theorized the concept (Thye (2000)). Hundreds of articles have since been published in organizational research analyzing power from almost all possible viewpoints and concentrating on various aspects and antecedents of power. In section two, I shall go into more detail regarding some relevant conceptualizations of power, but the main determination remains still fairly similar. According to that power is ability to “get others to do things they would not otherwise do” (Baldwin (1980, p.501)).

As suggested, it may not be beneficial always to develop new tools and frameworks, for example, in entrepreneurship research but to “use the theoretical tools already developed within psychology, sociology, economics, and various branches of business research” (Davidsson (2003, p.52)). Accordingly, I will examine the applicability of power and more specifically the applicability of power and dependency, power balance/imbalance and sources of power i.e. coercive, reward, expert, legal/position and referent power in the context (French and Raven (1959); Emerson (1962); Casciaro and Piskorski (2005)).

The examination of power in the current research setting in particular seems relevant for the following reasons. First, power constructs have been very extensively studied in organizational research. For example, Pfeffer and Salancik’s (1978) classic publication of resource dependency theory has yielded more than 2,300 citations as of spring 2002 (Pfeffer and Salancik (2003)). Consequently, this research tradition could potentially provide valuable insights into this special interfirm context: the relationship between entrepreneurs and their investors. In addition, for example, Santos and Eisenhardt (2005) suggest that power conception may be especially suitable in environments that are characterized by limited competition, which is common in entrepreneurial financing (Sahlman (1990)). Second, the power approach is very limitedly utilized in the entrepreneurial finance context. As far as I am aware, there is no study that has to date concentrated on power aspects in entrepreneurial finance. Considering the increasing importance of entrepreneurial firms for economies and job creation (Denis (2004)), it seems relevant to use all means available to increase our understanding of the phenomena. Third, previous theoretical approaches have provided important insights into the relationship but several critical questions remain unanswered. For example, different involvement levels of investors (i.e. hands-off vs. hands-on approach) have not shown a consistent correlation with the performance of ventures (Macmillan et al. (1989); Busenitz et al. (2004)). Another intriguing question is the very high emphasis investors
(especially VCs) place, while making investment decisions, on entrepreneurs’ personal characteristics and experience. A common saying is that investors prefer investing in B-class business ideas with A-class management to A-class business ideas and B-class management. However, entrepreneurial research has found very little empirical support for the idea that a certain combination of characteristics and experience correlates with performance (Gustafsson (2004)) and, hence, I try to offer new insights that are needed to understand these critical issues better and eventually resolve them.

I shall base my analysis on the case data that I collected during a period of eighteen months as a business angel of one entrepreneurial venture in Finland, plus interviews and other qualitative material. However, where relevant, I shall link the discussion to both the formal venture capital and business angel contexts. When I discuss both groups together, I shall use the term “investor” and when the distinction is relevant I will use the terms business angel (BA) and venture capitalist (VC).

I. Entrepreneurial finance and power

Business angels and professional venture capitalists constitute two main sources of equity funding for entrepreneurs. Business angels usually concentrate on the very early stage investments while professional venture capitalists prefer to invest in more mature firms. One way to illustrate the investment propensities of the parties is as a continuum where business angels represent one end and professional venture capitalists the other (van Osnabrugge and Robinson (1999)). Venture capitalists and business angels have other relevant differences than just the stages of the firms that they invest in, such as the source of capital, motivation of the investment, involvement level and style, and contracting mechanisms. In short, business angels invest their own wealth; are motivated in addition to capital gains by personal benefits accruing from their involvement in entrepreneurial ventures; they prefer a more hands-on approach and style; and are not that demanding in drafting legal contracts. Professional venture capitalists, to the contrary, invest limited partners’ money (e.g. insurance companies and pension funds), are almost purely motivated by capital gains, and prefer tight legal contracting and a more hands-off approach (De Clerq et al. (2006)).

Below I introduce two main theoretical approaches that have been utilized to explain the relationship of entrepreneurs and their investors. I then discuss the current literature on power in entrepreneurial finance. Finally, I shall discuss the more general literature related to power and present a summary at the end of the section, along with four propositions that I will test in the following section.

A. Two main approaches to explain the investor-entrepreneur relationship

The existing literature identifies at least two main approaches\(^1\) to conceptualize entrepreneurs’ and their equity investors’ relationship. The first relies heavily on ideas about the separation of ownership and control and draws its insights from agency theory (Jensen and Meckling (1976)). The second approach emphasizes the relational aspects of the relationship such as trust, respect, fairness, justice, timely feedback, and communication (Sapienza et al. (2000)). The first approach is motivated by the idea that investors provide funding to entrepreneurs but are not able to control fully how entrepreneurs use that funding. Therefore, it

\(^1\) Other frameworks and approaches have also been utilized in entrepreneurial finance, such as resource based view, prisoner’s dilemma, incomplete contracting theory and transaction cost economics (Wright et al. (2003)).
is in investors’ interest both to post penalties and rewards that should influence entrepreneurs’ behavior, and to monitor entrepreneurs, and, hence, increase the chances that the entrepreneurs behave according to investors’ interests. Agency problems emerge for the following reasons. First, principals’ (i.e. VCs) and agents’ (i.e. entrepreneurs) goals are different. The VC is interested in maximizing the return of the investment portfolio whereas entrepreneurs might gain personal benefits from acting as company officers and may, therefore, not be as interested in increasing the value of the venture. Second, it is often difficult for principals to know what the agents are doing, which could in turn increase the uncertainty between partners and worsen the agency problem. Third, entrepreneurs and VCs have different attitudes towards risk, which may lead the partners into behaving differently in the same situation (De Clercq and Sapienza (2001); Eisenhardt (1989B)).

The second approach relies on the ideas of justice theories. The main suggestion of this approach is that when the less powerful party (usually the entrepreneur) is treated fairly and in a procedurally just manner, he or she is more likely to behave according to the decision makers’ interests. This approach, therefore, provides insights into how the less powerful party (i.e. usually the entrepreneur) responds to the orders and commands of the other party. In addition, according to this approach, persons who are not able directly to influence the decision making might be interested in the fairness of decision making, and the process of decision making since it could provide them with a method to influence indirectly the decisions (Thibaut and Walker (1975)). Previous research has shown that a person’s perception of fairness has a significant impact on their commitment to decisions, performance, behavior and attitudes across many different settings (Kim and Mauborgne (1991); (1993)). Three factors have also been identified that influence an actor’s perceived procedural justice. First, standing is used to describe an actor’s status in the relationship. For example, a VC that treats entrepreneurs with respect and does not force its views on the entrepreneur is more likely to earn high respect and perceived procedural justice from the entrepreneur. Second, neutrality implies that a party (i.e. a VC) who makes decisions behaves neutrally towards all actors (i.e. all portfolio companies of the VC) and is willing to change its view when new information becomes available. Third, trust relates to the assurance that the decision-making party behaves trustworthy and predictably. In the VC-entrepreneur context, a VC that does not exploit its position in order to gain short-term benefits is more likely to earn high trust and accordingly perceived procedural justice from the entrepreneur (Busenitz et al. (2004)).

Empirical studies have shown the applicability of the constructs of ownership and control in the entrepreneurial finance context. For example, Sapienza and Gupta (1994) demonstrated that VCs can reduce entrepreneurs’ opportunistic behavior by monitoring entrepreneurs. Manigart et al. (2002) found evidence that monitoring should lead to a higher return from a portfolio company. Van Osnabrugge (2000) compared VCs’ and business angels’ investment processes. He utilized agency theory approach in his study and found strong support for agency theory’s applicability in the VC-entrepreneur relationship. He found that a VC tends to emphasize actions, which decreases the information asymmetry by conducting detailed investment analysis and concentrating on writing comprehensive investment contracts.

Similarly, attempts have been made to explain relational aspects between VCs and entrepreneurs. For example, Sapienza and Korsgaard (1996) utilized procedural justice theory in order to explain entrepreneurs’ and venture capitalists’ relationship. According to the authors, considerations other than economic ones play an important role in explaining the relationship. Busenitz et al. (1997) suggested that when the VC-entrepreneur relationship is
weak and is not based on trust, collaborative discussions are less likely occur. In addition, the scholars showed that strict contract covenants utilized by VCs, and entrepreneurs’ experience, decrease entrepreneurs’ perceived fairness towards VCs.

In sum, both approaches have considerably advanced our knowledge and understanding of the investor-entrepreneur relationship and highlighted the importance of (1) contractual relationship, (2) post-investment monitoring and (3) trust and communication in the relationship. However, we still know very little of whether power that has been identified as a major attribute in other organizational contexts (Lee and Tiedens (2001)) has any implication in this context. In addition, the dynamic nature of the entrepreneur-VC relationship has attracted only a little attention. However, the relationship is usually in constant flux and, therefore, dynamic approaches are needed. For example, Cable and Shane (1997) have utilized the prisoner’s dilemma approach to explain entrepreneurs’ and VCs’ relationship. According to the authors, prisoner’s dilemma relates to agency theory but contains more dynamic elements than static agency theory and takes into account the fact that also the principal (i.e. VC) can behave opportunistically. The nature of prisoner’s dilemma (a multi-round setting) also covers the situation where a party’s behavior reacts and responds to the other party’s behavior and vice-versa. Similarly, in an entrepreneur-VC relationship, power can vary constantly and the dynamic analysis of power is well founded (e.g. longitudinal case study).

B. Power in investor-entrepreneur relationship

The power aspect between entrepreneurs and investors is rarely discussed in the entrepreneurial finance literature. One rare exception is Bowden’s (1994) economic study of bargaining power, where he argues that venture capital funds’ size influences the bargaining power of the investor. Cable and Shane (1997) have suggested in their conceptual paper utilizing prisoner’s dilemma that venture capitalists and entrepreneurs are interdependent actors whose success depends on the other actor’s behavior and vice-versa. Fried and Hisrich (1995) suggest that venture capitalists have three sources of power; money, personal relationships and formal power. In money power, the authors refer not to the capital that investors have put into the company, rather that which investors potentially may invest in the company in the future. Relationship power is a result of investors’ time and effort put into the entrepreneurs’ venture, which in turn increases the entrepreneurs’ trust in and respect for the investors. According to the authors, this kind of power is mostly preferred since it is more enjoyable to use but at the same time may be hard to attain. Formal power is based on, for example, board, voting and liquidation rights determined between entrepreneurs and investors in the investment negotiations (Kaplan and Strömberg (2003)). According to Fried and Hisrich (1995), it may be that investors are not that willing to use their formal power since it is highly confrontational. In addition, the authors suggest that formal power is often least important to VCs and especially to early stage investors due to the relatively higher importance of money power. The authors largely neglect entrepreneurs’ power. Wright and Robbie (1998) present in their literature review article several examples of power in the relationship; for example, entrepreneurs’ power while negotiating additional funding, entrepreneurs’ power in VC backed MBOs, and the power of the parties in the exit decisions. Fiet et al. (1997) showed that the larger board size of VC backed ventures is less

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2 See a more detailed explanation of prisoner’s dilemma in Grant (2004).
likely to lead to dismissal of management team members, suggesting that larger boards lack the cohesion that is needed for decisive actions such as dismissal. In addition, the authors showed, relating to power, that the increase of VC controlled board seats leads to increased propensity for dismissals. In sum, none of the above-mentioned studies have taken a more in-depth approach to power but have still implicitly suggested that investors have more power in the relationship. This leads to research question one:

Is it so that investors are more often the more powerful party in the relationship?

C. Power constructs in organization research

One way in which to conceptualize power is as “a characteristic of interpersonal relationships” (Lee and Tiedens (2001, p.45)). This relational perspective on power can be divided into two parts. The first perspective concentrates on the social aspects of power, while the second concentrates on the dependencies and interdependencies of the individuals (i.e. whose power is of interest). In the social network perspective, all individuals are organized in a network and one’s objective and observable position in the network determines one’s power over the other members of the network. The second perspective relates to individuals’ dependency on each other. An extensively quoted early article of Emerson (1962) explains power as follows: “The power of A over B is equal, and based upon, the dependency of B upon A” (p.33). In other words, the higher the dependency of an actor, the higher the power of the resource holder.

The constructs of power, dependency and interdependency seem especially relevant in entrepreneurial finance. Both investors and entrepreneurs have only a limited number of suitable exchange partners and high quality goods. From the investor’s point of view, once the investment has been made there is often no short-term substitute for the entrepreneur as an exchange partner, at least not without cost (Fiet et al. (1997)). The entrepreneur provides the investor with the possibility to participate in a high growth venture, and with future growth and revenue opportunities. In addition, the entrepreneur may provide for business angels the possibility to participate in an interesting business which provides personal benefits for the business angel. Investors’ “goods” that they exchange with entrepreneurs are not only funding but also nonfinancial advice and benefits that could help entrepreneurs to be successful and develop their business. Similarly, entrepreneurs do not have a broad supply of substitutes for the investor (Sahlman, 1990).

In addition to dependency, the concept of power balance and imbalance has attracted attention in organizational research and it has relevance in the entrepreneurial finance context\(^3\). Casciaro and Piskorski (2005) have discussed in detail the power balance and imbalance between firms. They have showed that power balance and imbalance are two distinct dimensions of interdependency. A high mutual dependency between partners creates an incentive for them to act in a co-operative manner (i.e. absorb constraints). In contrast, in a scenario of power imbalance, the less powerful party may have incentive but little leverage to negotiate a fair deal with a more powerful party, who in turn would have little incentive and high negotiating power. In the entrepreneurial finance setting, a practical implication could be

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\(^3\) For example, entrepreneurs’ low power and, in turn, investors’ high power may in the worst case lead to failure of the venture (see e.g. Steier and Greenwood (1995)). On the other hand, it has been suggested that entrepreneurs possess considerable power in operational issues of the venture (Cable and Shane (1997)).
that a mutually dependent entrepreneur and investor would have more incentive to negotiate a fair deal and behave co-operatively compared to a situation of power imbalance between partners. This leads to research question two:

How does power and power balance influence the transfer of nonfinancial benefits and co-operation between parties?

The final aspect of power that I shall discuss is different power sources. I will utilize the typology that was originally developed by French and Raven (1959). It includes five power sources: coercive, reward, expert, legal/position and referent, which are briefly discussed below.

- **Coercive power** refers to the more powerful actors’ use of “stick” as a power source. In extreme cases, it could mean even a physical punishment but often it is a severe consequence for one who is not following the actor’s lead. In the entrepreneurial finance setting, it could refer to investors’ possibilities to punish entrepreneurs who are not following investors’ suggestions. Examples of coercive power could be the possibility to dismiss an entrepreneur or the denial of additional funding.

- **Reward power** refers to the more powerful actors’ possibilities to reward the other party. The reward can be either monetary or non-monetary. For example, a manager can offer bonuses or other incentives to well-performing employees. Reward power has a linkage to coercive power: depending on the actors’ behavior, the more powerful party can use either coercive or reward power. In the entrepreneurial finance context, investors have several possibilities to “reward” their portfolio firms. For example, just allocating investors’ time to help entrepreneurs can be a major reward for entrepreneurs (Sahlman (1990)).

- **Expert power** relates not to an actor’s formal position and the power that it bestows, but to the actors’ knowledge and expertise that others consider valuable. A good example is the increasing power of IT departments in firms. The more critical the IT systems become, the more power IT experts and system administrators gain. Entrepreneurs acquire equity funding for different reasons (Hellman and Puri (2002)). In some cases, the nonfinancial aspects are estimated to be even more important than the financial (Ehrlich et al. (1994)). This can be interpreted to lead to a situation where an entrepreneur who is seeking high nonfinancial benefits is more dependent and willing to follow the investor’s lead, in order to ensure that she/he would gain those nonfinancial benefits from the investor. Examples of critical nonfinancial benefits that entrepreneurs may be seeking are access to networks, image improvement and strategy consultation. Consequently, an actor that provides high expertise also possesses high expert power over another party to the relationship.

- **Legal power** relates to an actor’s legal position in the unit or group. For example, an investor often possesses considerable legal power that is determined in shareholder’s agreements and other investment documents. In addition, entrepreneurs who are a venture’s employees and co-owners possess legal rights.

- **Referent power** refers to the situation where a skilful user of such power gets people to do things without force, expertise and formal position, but just by being “such a nice guy”.


The discussion of the different power sources above leads to the third and final research question:

**What are parties’ power sources and do they vary according to situation?**

**II. Methodology and data**

The data for this article are based on my eighteen month period as an investor in one entrepreneurial venture in Finland. The involvement started during summer 2004 and ended in winter 2005. During that period, I systematically stored all the material that was distributed and produced. In addition, after the involvement, I conducted four interviews with the entrepreneurs. Below, I discuss in more detail the data sources, data collection, participant observation methodology and case study research that this article is based on.

Data collection for empirical research projects usually starts with random sampling, meaning that a sample of observations is collected from the population in which the characteristics are of interest. In case study research, it is often theoretical sampling that is being utilized (Glaser and Strauss (1967)). The purpose of theoretical sampling is not to choose observations randomly but to select cases that should represent the phenomena of interest well, and in which access deep under the surface is possible. The purpose is that by gaining such access it is possible to research complex constructs and, for example, causalities, better than in surveys. When studying complex constructs, such as power and the dynamics of power, a deep understanding is especially important.

**A. Data sources**

In entrepreneurial financing, the empirical studies are based on either one side of the relationship (e.g. surveys of entrepreneurs or investors) (see e.g. Van Osnabrugge (2000) or Barney et al. (1996)) or cover both sides of the relationship (see e.g. Sapienza (1992)) The third group of studies relies on secondary information such as data from Venture Economics or Venture One (see e.g. Gompers (1995)). The fourth category is in-depth case studies (see e.g. Sweeting and Wong (1997)). My approach follows the latter research tradition. The data cover, for example, over 300 e-mails, 15 discursive sessions (using Skype voIP software), 11 versions of business plans, six versions of the shareholder’s agreement and investment agreement. In addition, I have conducted four interviews with the entrepreneurs. The interviews were mostly transcribed applying the “24-hours’ rule” (Bourgeois and Eisenhardt (1988)).

**B. Case study research and participant observation methodology**

The purpose of the research project is to examine the applicability of power constructs in the entrepreneur-investor relationship. I have derived research questions from the theory and existing research, and answered them using case study methods such as pattern matching, the presentation of rival explanations, establishing a chain of evidence, and emphasizing quotes and narratives from the data. Data collection has been achieved, among other means, through participant observation methodology which, according to Yin (2003), is a special data collection method where a researcher can have at least four kinds of role: (1) a member of the setting, (2) a partially active member of the setting, (3) an active member of the setting and (4) a key member of the setting. My role in the setting most closely resembled that of a key member.
Case studies have been used in the entrepreneurial context before but participant observation methodology has rarely been employed in the entrepreneurial setting. I was able to find only one example in the entrepreneurial finance context, namely Silva’s (2004) study of a Portuguese venture capital firm’s investment strategy and process. However, several aspects speak for using this kind of methodology. First, it is very difficult to obtain data on venture capital investments, especially in longitudinal form. The same applies to business angel investments. Angels often want to remain anonymous and acquire information about potential deals through intermediaries (van Osnabrugge (2000)). Second, it is not necessarily possible to get answers concerning complex issues such as power in the relations and the dynamic nature of power from interviewees in a few interviews or surveys. This viewpoint is supported by Beaver and Jennings (2005, p.21):

“Researching small business management competence and the quest for competitive advantage is fraught with difficulties. The relationship between enterprise performance and management action and inaction is extremely tenuous and very difficult, if not impossible, to demonstrate conclusively. Only those persons immediately affected by organizational events have sufficient knowledge of the precise circumstances to be able to suggest cause and effect relationships.”

Third, it is suggested that current venture capital research projects that are either based on surveys or secondary databases need additional data sources to increase our understanding of the phenomenon (such as observation studies) (Fenn and Liang (1998)).

C. Evaluation of the quality of the research
Key concerns promoted, for example, by Yin (2003) in case study research – reliability, construct validity, internal and external validities – were considered in detail when I designed, conducted and finally wrote the research project report. Internal validity, relating to cause-and-effect relationships, was increased by conducting multiple interviews, a careful analysis of different data sources, pattern matching and the presentation of rival explanations. The generalizability of the results outside of this data (i.e. external validity) was conducted by utilizing the existing literature and analytical generalization. The third concern promoted by Yin (2003), construct validity, was a major issue since I participated actively in the research setting. I have increased construct validity primarily through the extensive utilization of various data sources, key informants’ review of the report, and the establishment of a detailed chain of evidence between analysis, propositions and data. Reliability was increased using the case study process framework promoted by Eisenhardt (1989A). The same framework was used by Fried and Hisrich (1995) in their study of a rare example of power in the entrepreneurial finance context. In addition, I established a common database for all material and a “data room” where the data were analyzed in a consistent manner. I have summed up the four key concerns of the case study research, following the example of Sarker and Lee (2003, p.818), in Table I.

III. The investment and power relationships
In this section, I will discuss my involvement with the entrepreneurs by concentrating on the power aspects. The venture had been operating as a part-time hobby of the two founders
for approximately two years before my involvement. There were no additional employees. The venture sold DVD movies on the internet. The founders wanted to import a new movie rental concept from the U.S to Finland, where the venture was operating. The concept had been very successful in the U.S. The business idea was fairly straightforward. Customers paid a fixed monthly fee, selected movies online and the movies were then delivered to the customers by mail. The customers could keep the movies for as long as they wanted but they could not receive new movies prior to returning the previous ones by mail.

The initial contact between the entrepreneurs and myself was established in June 2004. I became interested in the business opportunity presented by entrepreneur ONE. They were not actively looking for an investor but rather searching for different methods to finance their venture. I became interested mainly because the business concept had been extremely successful in the U.S., and because there were no competing businesses in Finland at that time. I also recognized an opportunity since the entrepreneurs needed additional finance and it was unlikely that they would be able to raise it without more experienced people committed in the venture. Consequently, I negotiated that I would get approximately 1/6 of the shares in return for a small capital installment and “sweat equity” that I was willing to put into the venture.

I did not have an official operational role in the venture. I acted in an advisory capacity and, in addition, helped to put together a business plan and raised some additional debt financing and grants from governmental sources. I also helped to launch the service and had a seat on the company’s board along with the entrepreneurs. There were no additional board members. My motivation for the investment was primarily to get involved in the entrepreneurial venture and secondarily for financial gain.

It took almost a year from the initial contact to launch the service. After only three months in operation, the entrepreneurs came to the final conclusion that the service was not going to succeed. The main reason for the termination of the project was the lack of customers resulting from the highly unprofessional graphic design of the service. Due to its successful launch, the concept was able to attract a considerable number of people to the website, but potential customers were not willing to sign up due to the image that the poor design created. The second reason was that the profit per customer was much lower than we had anticipated.

Interviews with the entrepreneurs clearly showed that they were concerned about the control of the firm before they agreed to my investment. For example, they agreed beforehand that should problems arise they would always team up against me. This was presented by entrepreneur TWO in the following quote:

\[E1]\; “We agreed beforehand that in case of disagreements we [the entrepreneurs] would discuss the issue together and decide the best course of action for ourselves [so that our interests would be protected].”

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4 In order to preserve anonymity, I shall call the entrepreneurs ONE and TWO.
5 This was due to various reasons, such as: 1) customers returned movies sooner than what we expected which increased our postal fees 2) Finnish postal agency charged more postal fees than what they had originally quoted due to their own error, 3) more movies got broken and lost than what we had anticipated 4) movies cost more than what we had expected due to the reason that movie distributors added extra shipping fees that we had not anticipated when they delivered the movies. All these costs decreased our profit per customer considerably.
6 I will refer to these interviews and e-mail quotes later in Table II and the text and, hence, I have numbered them as evidence (E1, E2 etc.).
Prior to and after the investment we worked hard to develop the concept. During the development phase, I tried to offer my advice and, for example, made several suggestions about the content of the service. I also emphasized some aspects that I felt to be especially important, such as improved communication among us, and the image which the service created for the customers. Consequently, I made specific suggestions about how we could improve these aspects and ensure that they would be sufficiently taken care of. For example, I suggested that in order to improve the quality of the graphic design and user interface of the software, we should consider recruiting additional resources. In addition, I pointed out that it is very risky for only one person to be responsible for all software development, which was highly critical to the business. I even suggested a suitable person to aid in the software development. However, the entrepreneurs turned these suggestions down as a quote from an e-mail on April 5th, 2005 illustrates:

[E2]: “I or [entrepreneur TWO] do not see that we need additional programming resources. Therefore we can forget this issue. Let’s see if there is a need for that later but now there is none.”

In addition, I made several suggestions as to how we could improve marketing. For example, I suggested that we should have a marketing plan where we would broadly define at a high level the targets of our marketing attempts. My suggestions were largely ignored.

Returning to the power sources presented by French and Raven (1959): coercive, reward, expert, legal and referent power, and the concept of power imbalance (see e.g. Casciaro and Piskorski (2005)), it seems that I had very limited power in the relationship. I did not have any coercive power or in fact any real interest in using coercive power. I did not possess any considerable reward power, since I was not in a position to provide any large-scale additional funding for the entrepreneurs. Neither did I possess any other resource that would have been valuable to the entrepreneurs. I may have had some expert and referent power but they were fast deteriorating. Entrepreneur TWO explained that at first they tried to follow and implement my suggestions in detail but soon decided that “there are more important matters”. According to entrepreneur TWO, it seems that an investor with relevant experience and reputation would have possessed more power in the relationship, as the following quote shows:

[E3]: “If we would have had a person who would have been familiar with movie business as an investor, I believe that he would have been able to provide instantly ideas that would be aligned with business logic of that particular business area.”

The following quote from an e-mail from entrepreneur ONE also implies that my referent power was very limited in the relationship (e-mail dated May 16th, 2005):

[E4]: “If we had a real venture capitalist as an investor, of course we would provide the information that he would require.”

In other words, more relevant experience and reputation would have provided more power for the venture’s investor. However, I did not possess the critical resources that the entrepreneurs assessed as valuable, nor did I manage to influence the entrepreneurs by using
referent power or any other power source. Consequently, I maintained very little power in the relationship.

Due to my low power, I also had problems in getting information about what was going on in the venture. I, for example, sent correspondence saying that I would be interested in knowing what is going on in order to provide useful comments for and timely help to the entrepreneurs. However, due to time constraints, the entrepreneurs were not very concerned about the information that I was getting, as entrepreneur ONE wrote in his e-mail of May 16th, 2005:

[E5]: "Of course information comes to you later [days or in some occasions weeks], but the main point is that we know what we are doing."

The next two quotes from entrepreneur TWO after it was certain that the venture was going to fail illustrate the obvious dilemma (i.e. that my comments were actually considered valuable):

[E6]: "It was damn good that you scrutinized our plans in such detail…[it saved us from putting even more effort and resources on the failing project].” and:

[E7]: “Since you looked at the business from the outside you provided quite wild ideas, which might have been the answer if we would have executed them [i.e. the venture would not have failed].”

At least two aspects emerge from these experiences. First, since my power was very limited and even though I saw serious shortcomings and tried to react to them, my suggestions and advice were largely disregarded. This was really problematic for me since my initial motivation to invest was to get involved in a new and exciting venture. The entrepreneurs’ opinions illustrate well how they thought about the investors. First, a quote from entrepreneur ONE and then from TWO:

[E8]: “It is ok that an investor interacts and provides help but without question the entrepreneurs should always have the final say on any given issue. If, for example, it is not possible to reach a compromise then the entrepreneurs’ opinion should win.”

[E9]: “When there was a conflict of opinions the majority decided [i.e. usually the entrepreneurs’ opinion].”

The entrepreneurs’ view of the investors’ role is very different from that, for example, which professional venture capitalists favor (see e.g. Pratch (2005)), and also business angels tend to get involved more closely in the ventures they invest in (Van Osnabrugge (2000)). From my point of view, i.e. a person who wanted to be involved in an entrepreneurial venture, I soon learned that it was not that easy to influence an entrepreneurial venture and that I would not get the personal benefits from the investment that I had expected.

Second aspect that emerges from the mismatch between my attempt to provide advice and the entrepreneurs’ reluctance to listen is why was the communication and advising so difficult? Especially since the entrepreneurs admitted later that they should have paid more attention to my propositions. Entrepreneur TWO’s quotes shed some light on this aspect:
“I think that we had some kind of a collision of cultures here. Your communication style is very aggressive [direct] and if one is not used to it one may end up denying everything that the other person is promoting. I know that it happened to me as well.”

In order to illustrate his point, entrepreneur TWO gives a short example about a board member of another firm:

“This particular board member tells a story, who knows whether it is imaginary or not, with many illustrative examples and listeners usually discover themselves what he is suggesting. This style does not criticize anybody personally and could have worked well in our firm as well.”

In other words, the explanation offered by entrepreneur TWO was that the entrepreneurs were not willing to listen to the comments and advice since the communication method was wrong (too aggressive and direct) for them. According to Cousins (2002) and Casciaro and Piskorski (2005), given high power imbalance the more powerful party tends to place less emphasis on the less powerful party’s opinions and interests. Consequently, the entrepreneurs’ high power may have lead to the situation where they did not want to put more effort into those issues that they did not see as useful.

We launched the service in July 2005 and got a lot of publicity in the Finnish press considering the size of the venture. However, after only one month entrepreneur ONE’s belief in the concept started to shake. He wrote in his e-mail of August 9th, 2005:

“We have had visitors from 6000 different IP-addresses [meaning different customers had visited the service’s website] and we have gotten 40 customers... In addition our profit per customer is on average 1.5 euros per month... In sum my feeling of success on a scale 0-100 is pretty close to zero”

After that e-mail we started seriously to analyze our options. I suggested that we should try to intensify our efforts to attract customers and openly evaluate possibilities to co-operation with other players. We decided that we would wait one more month and meanwhile try to increase the number of customers considerably. Unfortunately, the results were not very encouraging and, hence, we started to look for an exit. I had used common stock when I invested in the venture and I did not have the protection of a liquidation preference clause. This put me in a very unfavorable situation in a low valuation trade sale or in liquidation. Therefore, I had an incentive to continue the venture even though the possibility for success was very low. However, the entrepreneurs disagreed and wanted to exit the business as soon as possible. After a few months of searching, the entrepreneurs found an owner of a video rental chain that

It seems that the communication style was a major issue that caused a great many problems between us. Previous research has emphasized the importance of communication between investors and entrepreneurs (see e.g. Busenitz et al. (2004)). Interestingly, correct communication style has not received in-depth attention and could be a subject for future research. However, this research project does not concentrate on it.
wanted to expand into the mail rental business, and they agreed to sell the business to him at a lower valuation than that we had put into the venture.

The shareholder’s agreement stated that all board members should agree on major decisions including ownership restructurings and changes to board membership. This clause provided me with an effective method to veto unfavorable decisions that were considered “major”. Even though I was against the trade sale, I had very few options to make the entrepreneurs actually do something that they would not otherwise want to do i.e. to continue the venture’s business in one way or another. Due to my limited options, I offered the entrepreneurs the possibility to buy back my shares at a lower valuation than I had initially paid for them, but still a higher valuation than what my share of the proceeds of the trade sale would have been. The entrepreneurs, who wanted to exit the firm as soon as possible, did not have any other realistic options than to agree to the proposition, and I sold my shares back to them before the venture’s business was sold to the third party.

Based on the case description above, it is probably clear that the entrepreneurs held considerable power over me and the power was imbalanced in our relationship. Based on the interview data, it seems that the power imbalance had influenced the entrepreneurs’ willingness to evaluate seriously the suggestions that I made. Based on the existing literature, it has been suggested that VCs in particular possess high power over entrepreneurs and their power bases are legal, expert, coercive and sometimes referent and reward power. Business angels, who prefer post-investment involvement, may consequently utilize more expert and referent power compared to the other power sources. In my case, the entrepreneurs held considerable power over the investor. This is particularly interesting since the existing research suggests that entrepreneurs’ power may decrease when their venture is not developing according to plan (Fredriksen and Klofsten (2001)). In our case, the venture was developing poorly but still the entrepreneurs held considerable power and actually their power increased as a result of the poor development. In more detail, the entrepreneurs held considerable power relating to the day-to-day operations of the venture and the strategy of the venture, and they disregarded suggestions that I made. However, I would have been very reluctant to invest additional funds in the venture. Also, due to the high risk and fairly pessimistic outlook for the venture, it would have been difficult for me to dismiss the entrepreneurs (it was very unlikely that anybody would have been interested in starting to work in the venture on similar terms), and this provided them with considerable but only partial power. Utilizing the power dependency typology, I was more dependent on the entrepreneurs than they were on me. However, the power dependency was related to day-to-day activities and business strategy aspects.

Relating to the second research question of transfer of nonfinancial benefits and co-operation, the entrepreneurs disregarded suggestions that were not attractive from their point of view or they gave them “two seconds” before they did so, as confessed by entrepreneur TWO. However, entrepreneur TWO confirmed in the interviews that this led to a situation where most of the ideas, even good ones, were rejected since the entrepreneurs used their power and decided to do things their way. This suggests that power balance influences the transfer of nonfinancial benefits and co-operation. A similar aspect was identified by Casciaro and Piskorski (2005).

I was not entirely powerless in the relationship, and, due to my legal power, I was able to negotiate a fairly good exit from the unprofitable business. I also had some power when we started our relationship, but soon the entrepreneurs started to disregard my suggestions and requests (my referent power was decreasing). The entrepreneurs also admitted that if they had
had an experienced venture capitalist as an investor, they would have behaved differently (suggesting that a professional venture capitalist would have possessed more referent power). Finally, I had some expert power while I negotiated additional financing from the government. In turn, the entrepreneurs had high power that was mainly based on their formal position as company executives (legal power) and on my limited possibilities to find replacements for the entrepreneurs (partly expert power).

In Table II, I present the summary of the research questions and case study evidence.

IV. Discussion

In this paper, I have examined power in the relationship between investors and entrepreneurs. I have employed the case study approach and participant observation method. I have been able to document and analyze in depth one entrepreneurial venture’s interactions based on actual decisions and behavior. In addition, I have interviewed the entrepreneurs afterwards to examine their perceptions of power in even more detail.

As my data and the power literature suggest, it seems that power constructs are constantly present in the relationship and they influence actors’ behavior. It also seems clear that power is a more complex construct in the entrepreneurial finance context than Fried and Hisrich (1995) have suggested. Contrary to their propositions, this study suggests that it is not always the investor who has the power. Entrepreneurs have power that is drawn from different power sources, such as legal and expertise power. Constructs such as dependency, power balance/imbalance, and different power sources, contain all important issues that could help us understand the relationship between entrepreneurs and investors better, and also in an optimal situation to influence the actors’ behavior.

Further studies on power could first benefit by making a distinction between different power sources. For example, Pfeffer (1992) suggests that acknowledging various power sources is in itself a major power source. From the investors’ point of view, it may be crucial to build different power sources. For example, VCs’ high emphasis on extensive ex-ante contracting (referring mainly to coercive, reward and legal power sources) seems somewhat limiting. VCs’ own interest and that of their limited partners requires them to ensure that the capital is invested as efficiently as possible. Based on my analysis, the development of additional power sources could help to reach that goal. It may also be the case that the importance of different power sources depends on the development phase of the portfolio firm. For example, Fried and Hisrich (1995) have suggested that formal power is more important at the later stages of ventures. Similarly, the importance of fairness and trust in the entrepreneur-VC relationship (Busenitz et al. (1997)) can be interpreted to support the recommendation of additional power sources such as referent power.

The typical business angel strategy of extensive ex-post involvement is not ideal either. By concentrating on building a relationship, referent and expert power may be sufficient on some occasions but probably situations arise when legal power, for example, is needed. My agreement with the entrepreneurs illustrates this. Due to the lack of a liquidation preference clause or usage of convertible preferred shares, I was at risk of losing almost all my investment. But the clause in the shareholders’ agreement that provided me with a veto on any changes in the ownership structure gave me a good negotiating position that eventually made the entrepreneurs buy back my shares. The second important insight into power constructs relates to business angels’ high need to get involved in the venture’s business. With low power this
may be impossible, and, therefore, the development of various power bases may be essential for business angels. The identification of and building different power sources is also important for entrepreneurs. For example, one major concern for entrepreneurs who are acquiring equity financing is the loss of control of their firm (Shepherd and Zacharakis (2001)). Also, my data (see E1) revealed a similar fear among the entrepreneurs. However, the skillful utilization of different power sources may help entrepreneurs to stay in better control of their firms. In sum, different power sources all play an important, partially complementary and partially overlapping, role in the investor-entrepreneur relationship. Their importance may vary depending on the situation and stage of the firm’s development. In order for the parties to manage their relationships successfully, all power sources may be needed, not necessarily constantly but occasionally during the relationship.

Another interesting aspect that emerges from the research data and previous power literature is the question of the amount of power between parties and power balance. It has practical implications and could be a target for further academic research. For example, in my case data the (powerful) entrepreneurs agreed afterwards that they should have considered some of the suggestions more carefully during the relationship. On the other hand, there are also illustrative examples of where the investor’s decisions are argued to have destroyed the entire venture or at least seriously delayed its development (see e.g. Steier and Greenwood (1995)). Without high investor power it is less likely to happen. Therefore, the question of what is the correct amount of power and power balance between entrepreneurs and their investors becomes significant. One way to illustrate this question is to consider three scenarios: first, power imbalance between a powerful investor and powerless entrepreneur; second, the opposite scenario; and a third scenario of power balance. The obvious question is whether one of the scenarios would be optimal compared with the others for the co-operative relationship or is it so that the venture’s industry or stage could have implications for optimal/suboptimal power between partners.

My data and previous research give some indicative answers. In scenario one, regarding high power imbalance in favor of entrepreneurs, it could mean that nonfinancial contributions potentially provided by the investor are less likely to be adapted by the entrepreneur (as happened in our case). In addition, it may be that the business angel is not going to gain the personal benefits that he/she expected from the investment. The opposite scenario of high power imbalance in favor of investors could mean that entrepreneurs, who often have a high need for independence (Brandstätter (1997)), will lose their motivation to work on behalf of the venture. On the other hand, sometimes investors will replace the entrepreneur who they perceive to be performing inadequately, and, on these occasions, the low motivation of entrepreneurs is not a problem for investors, due to the fact that investors believe that dismissals increase the performance of the firms (Bruton et al. (1997)). In sum, it is likely that both parties would prefer as high power as possible, but if the interest lies on the transfer of nonfinancial benefits and co-operation between partners, which should in turn increase the performance of the venture, then a more balanced distribution of power may be preferable as illustrated in scenario 2 (Casciaro and Piskorski (2005)). The three scenarios are presented in Figure 1.

One aspect that speaks for the utilization of power constructs in entrepreneurial finance is that power is virtually always needed when getting things done involves more than an actors own efforts. When we want to get things done, we virtually always need to influence people
who are not in our chain of command. In other words, we depend on the people we cannot
influence officially or at the very least our power is very limited compared to our
responsibilities (Pfeffer (1992)). One method to influence the actors that are outside our sphere
of (official) influence could be the skillful utilization of power. In the entrepreneurial finance
setting, this phenomenon is very well presented.

Another intriguing fact that speaks for using power constructs in the entrepreneurial
setting is that the power research tradition is much more developed than the entrepreneurship or
entrepreneurial finance research tradition. Consequently, and following for example
Davidsson’s (2003) suggestion concerning the utilization of previously tested
operationalizations of variables in entrepreneurial research, we could find more empirically
validated constructs that we could then test in the entrepreneur-investor context.

This study is based on the data of one relationship (i.e. a single case study) and,
therefore, caution is needed when interpreting the results (Yin (2003)). In addition, I have
employed a rather unorthodox approach by being an active participant in the research setting,
even though it has been suggested that this is “within the limits” of participant observation
methodology (Yin (2003)). The biggest concern the approach raises is the question of
objectivity. I have attempted to limit the problem of construct validity (Yin (2003)) by
extensively documenting and presenting the data. In addition, I have linked my arguments and
insights to the existing literature on power and entrepreneurship, which should further increase
objectivity. Moreover, to argue on behalf of the data collection method, without my active
involvement it would have been impossible to obtain as detailed data as I was able to collect
during my 18 months period of involvement with the entrepreneurs.

The second important issue to be noted is that previous power research outside the
investor-entrepreneur setting is very broad and established. However, I have concentrated on
only a very small portion of aspects within the notion of power, and at the same time have
excluded other interesting and without doubt relevant concepts and constructs that most likely
would have equally advanced the understanding of the relationship. For example, by choosing
to examine power sources originally presented by French and Raven (1959), I have also
disregarded some other sources of power (Morgan (1986)). Therefore, a more in-depth analysis
of power in the entrepreneur-investor context could be of interest than can be conducted in one
academic article.

The final limitation, and at the same time a suggestion for future research, is the depth
of various contract covenants and other agreement structures between entrepreneurs and
investors. In our relationship, my right of veto on changes in the ownership structure provided
me with a fairly good negotiating position and power that made the entrepreneurs buy back my
shares. However, there are various other contract covenants. Kaplan and Strömberg (2003)
have divided them into cash-flow rights, board rights, voting rights, liquidation rights and other
control rights. In addition, an effective method to control entrepreneurs is the staged financing
which VCs commonly use (Gompers (1995)). It could be very interesting to analyze in more
detail the association between various contract covenants and power between partners. In my
relationship, I had some power based on the investment agreement but the entrepreneurs
neglected that by disregarding my suggestions for the best strategy for the firm. Since I had no
effective methods to discipline the entrepreneurs for their behavior, I had to agree with them
against my will and my power was low. The interesting question remains as to whether this is a
common phenomenon or just an isolated incident.
Despite its limitations, my article sheds light on the role of power in the investor-entrepreneur relationship. I suggest that power constructs in entrepreneurial financing could provide several interesting research avenues and could even help us to understand what the optimal building block for a co-operative relationship between entrepreneurs and their investors would be. Going back to the one determination of power, “get others to do things they would not otherwise do” (Baldwin (1980, p.501)), is something that both entrepreneurs and their investors try to do continuously in their relationships, and therefore a more detailed academic analysis of that determinant would be well founded.
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Table I
Key concerns in case study research

<table>
<thead>
<tr>
<th>Key concern in case study Research</th>
<th>Suggestions from the literature (Yin, 2003; Eisenhardt, 1989A)</th>
<th>Notes</th>
</tr>
</thead>
<tbody>
<tr>
<td>Internal validity</td>
<td>Pattern matching</td>
<td>Research questions derived from the literature were matched with empirical patterns.</td>
</tr>
<tr>
<td></td>
<td>Address rival explanations</td>
<td>Rival explanations were presented.</td>
</tr>
<tr>
<td>External validity</td>
<td>Use of theory/existing literature</td>
<td>Existing literature was used to make connections between research data and the formal venture capital context.</td>
</tr>
<tr>
<td></td>
<td>Analytical generalization</td>
<td>The data were generalized to power theories.</td>
</tr>
<tr>
<td>Construct validity</td>
<td>Using multiple sources of evidence</td>
<td>1) Participant observations during a period of 18 months, 2) multiple interviews with both informants, 3) over 300 e-mail and other documents and material.</td>
</tr>
<tr>
<td></td>
<td>Having key informants review the case study report</td>
<td>Both entrepreneurs have reviewed an earlier version of this report.</td>
</tr>
<tr>
<td></td>
<td>Establishing a chain of evidence</td>
<td>Extensive linkage to interviews and other data in analysis.</td>
</tr>
<tr>
<td>Reliability</td>
<td>Developing a case study protocol</td>
<td>Protocol was developed utilizing Eisenhardt’s (1989A) suggestions including literature review, proposals, semi-structured questionnaires etc.</td>
</tr>
<tr>
<td></td>
<td>Creating/maintaining a case study database</td>
<td>All data were stored in digital form on a hard drive. In addition, a “data room” was established where data were analyzed in a consistent manner.</td>
</tr>
</tbody>
</table>
Table II

Three research questions and links to data.

<table>
<thead>
<tr>
<th>Research question</th>
<th>Notes</th>
<th>Links to evidence</th>
</tr>
</thead>
<tbody>
<tr>
<td>RQ1: Is it so that investors are more often the more powerful party in the relationship?</td>
<td>It seems that the investor’s power was very limited in this case. I had some referent power but it decreased when the relationship developed. My main power source was legal power during exit negotiations.</td>
<td>E1, E2, E3, E4, E5, E8 and E9</td>
</tr>
<tr>
<td>RQ2: How does power and power balance influence the transfer of nonfinancial benefits and co-operation between parties?</td>
<td>Based on the data, the entrepreneurs’ high power enabled them to disregard suggestions. In other words, power imbalance decreases co-operation and transfer of nonfinancial benefits. However, a rival explanation could be that the communication method was wrong.</td>
<td>E5, E6 and E7. See also E10 and E11 which suggest that a wrong communication style may have been the reason for the rejection of nonfinancial contributions.</td>
</tr>
<tr>
<td>RQ3: What are parties’ power sources and do they vary according to situation?</td>
<td>The entrepreneurs’ power was based on legal and partly expert power. The investor’s power was based first on referent power but later mainly on legal power. In sum, power is based on various sources and it changes according to situation.</td>
<td>E1, E3, E4, E8 and E9</td>
</tr>
</tbody>
</table>
Figure 1.

Three different scenarios of power balance and imbalance between an entrepreneur and an investor

(Inspired by Buvik and Reve (2002, p.267) and Casciaro and Piskorski (2005, p.171))
ARTICLE 4

THE ROLE OF ADVISORS IN THE VENTURE CAPITAL INVESTMENT PROCESS


Oskari Lehtonen
Tom Lahti
Despite the extensive research on venture capitalists and entrepreneurs, there is at least one group of actors whose role has been overlooked, namely advisors that specialise in helping entrepreneurs raise venture capital funding. This explorative study aims to fill this gap. Based on qualitative case study data, this paper shows that the activities of advisors have several benefits for entrepreneurs seeking funding. Advisors appear to accelerate the process of acquiring funding and improve the terms and conditions of the funding. By participating in the preparation of written documents that are required when approaching investors advisors can contribute to increasing the investment readiness of an entrepreneurial venture. They also typically participate in investment negotiations. This may reduce the possibility that negotiations between the venture capitalist and the entrepreneur become confrontational which could, in turn, adversely affect the venture capital–entrepreneur post-investment relationship. The findings in this study strongly suggest that using advisors increases the likelihood that entrepreneurs will successfully obtain venture capital funding. This paper recommends that inexperienced entrepreneurs in particular should seek support from advisors when seeking to raise venture capital.

Keywords: venture capital; advisory firms; investment readiness; equity gap; investment process
investment process; screening, due diligence, negotiations and contracting, post-investment involvement as well as exiting are all crucial ingredients in the modus operandi of VCs. The pre-investment analysis (due diligence) has been shown to be highly comprehensive (Fried and Hisrich 1994). In their due diligence VCs aim at reducing investment risks through considering all the aspects relating to the investment opportunity subject to funding: the entrepreneur (management), the firm, the product as well as the external environment (see e.g. Smart 1999; Kaplan and Strömberg 2003). Thus, the successful acquisition of funding can take more than six months to materialise (see Bruno and Tyebjee 1985). This suggests that for entrepreneurs raising venture capital funding is difficult and time consuming, and success is improbable. Therefore, a very important question emerges: what could entrepreneurs do to (i) increase their chances of acquiring VC funding and (ii) acquire funding to the best possible terms?

This study proposes that advisory firms may have an important role in helping entrepreneurs acquire VC funding. It will evaluate the influence of advisors on the investment procedures and the relationship between entrepreneurs and VCs. Specifically, this study will answer the following two research questions: (i) how do advisory firms operate? and (ii) what are the benefits and disadvantages of employing advisors for entrepreneurs who are looking to acquire VC funding? This is an important area of research, because advisors may have an impact on bridging the equity gap that exists when there are good investment opportunities that are unable to obtain funding. The study will contribute to the literature on investment readiness (Mason and Harrison 2001, 2004) that holds the view that entrepreneurs’ difficulties to qualify for VC funding relates to a great extent to shortcomings in written and oral presentations of their business opportunities. Advisor involvement can also contribute to reducing ‘equity aversion’ that arises from entrepreneurs’ lack of knowledge of the operating procedures of VCs (Mason and Harrison 2001). If advisor involvement is found to have positive consequences for the acquisition of VC funding, this study serves the function of promoting their value for entrepreneurs in need of funding. Drawing on the empirical findings, the implications of the actions of advisory firms is discussed.

The data for this study were gathered by interviewing five Finnish advisory firms, three entrepreneurs that have utilised advisors in acquiring VC funding and four VCs that have negotiated deals where advisors have been present at the investment meetings to assist entrepreneurs. To form a picture of the role of advisors insights are obtained from all the parties involved in influencing and shaping the investment agreement. The remainder of the paper is organised as follows. First, a brief discussion is provided that addresses the research gap and presents relevant previous research. Then, the methodology and the data used in this study are described. Thereafter, follows a presentation of the case illustrations. This paper concludes with a consideration of the theoretical and practical implications of the study and suggests future avenues of research on the topic.

Literature review

In presentations of VCs’ investment process (e.g. Tyebjee and Bruno 1984; Fried and Hisrich 1994) the basic idea is the same. First entrepreneurs and VCs make initial contact. The VC approaches the entrepreneur or vice versa. This phase is termed in the literature as ‘origination’ or ‘search’. Thereafter, the most unsuitable business
proposals are rejected. This phase is referred to as ‘initial screening’. Then a more in-
depth evaluation begins, and if successful the VC and the entrepreneur start
negotiating the terms of the investment. This may lead to an investment decision,
post-investment activities and finally to an exit. The existing literature focuses on a
dyadic relationship between investors and entrepreneurs, while in reality there might
also be a third party, the advisor, involved in structuring the deal. Lawyers are
commonly present when investment agreements are drafted. However, their
contribution is rarely analysed in academic studies. This study concentrates on
analysing specific advisors that help entrepreneurs acquire VC funding. This means
that the analysis goes beyond lawyers as advisors who evidently have the knowledge
to draft a legally binding contract, but who are not necessarily capable of
understanding the nature of the business to represent the best interest of the
entrepreneurs (Stevenson and Sahlman 1988). In order to obtain a definition of the
advisory services these specific actors in the market provide, they were in the
interviews asked to define their services to entrepreneurial ventures looking for VC
funding.

Based on existing research, this study will depict challenges and problems that
entrepreneurs face in the different phases in the venture capital investment process.
The review focuses on issues in which entrepreneurs probably need most support and
where support and assistance from advisors is likely to be most beneficial. The
literature review is divided into the following phases: (i) the search for capital; (ii)
first contact and screening; and (iii) negotiation and contracting. The review suggests
how advisors can support and assist entrepreneurs in each of these three phases.
There is very little research relating to advisors in the domain of venture capital.
Murray and Wright (1996) have studied the role of any kind of intermediary in buy-
outs financed by VCs. Among their data on 153 cases of UK-based management
teams, 46 cases were identified in which the advisor was not an accountant but a
lawyer, banker or specialist consultant. The advisor’s role had been, at best, a
modest influence in identifying potential VC partners. Hustedde and Pulver (1992)
obtained survey data on 318 entrepreneurs in Minnesota and Wisconsin, USA, who
had sought equity capital of $100,000 or more. According to their research
findings, obtaining assistance on technical issues, how to prepare a business plan
and where to seek funding influence positively the success of acquiring funding.
Sometimes advisors and business associates are mentioned as a source of
information for VCs (Fiet 1995) or as a resource in the VC due diligence process
(Van Osnabrugge 2000).

Surprisingly, the advisors’ role as a resource for entrepreneurs looking to
acquire VC funding has not been emphasised in previous research. Practical books
have, however, touched upon the subject. For example, Benjamin and Margulis
(2005), pinpointing strategies and guidelines for raising capital from business
angels, acknowledged the help entrepreneurs may receive when approaching
advisors.

In the small business management literature, the involvement of advisors has
been revealed to have positive consequences. Previous research demonstrates
that firms that use accountants and outside advisors are associated with
higher performance (O’Neill and Duker 1986; Chrisman, Hay, and Robinson
1987; Chrisman 1989) and nascent entrepreneurs that use outside advisors have
higher expected rates of survival, growth and innovation (Chrisman and McMullen
2000).
Search for capital

Entrepreneurs who have decided to start searching for VC funding face several challenges. They do not necessarily know how to locate VC firms, which VC firms to approach, how to approach them, what their operating procedures are, what kind of ventures VCs are looking for, how to write business plans, etc. (De Clercq et al. 2006).

Finland and larger VC markets such as the UK or the US may differ in terms of the possibility of accessing representatives of VC firms. Finland is such a small market that practically any entrepreneur can approach and organise a meeting with even the most prestigious VC firm. In larger markets, this may not happen as easily, which explains why referrals are essential (Fried and Hisrich 1994). However, unsuitable entrepreneurs are rejected very swiftly, even in Finland. This is when the first meeting leaves the VC with a bad impression of the entrepreneur. Therefore, it is crucial that the entrepreneur is well prepared for the first meeting. The adage that ‘you can make a first impression only once’ is very true in this business. Entrepreneurs may lack knowledge of how to approach VCs and so experienced advisors may be able to provide entrepreneurs with extensive support in developing a suitable strategy.

Entrepreneurs are not always seeking just money from VCs but may also recognise the other benefits that they can derive from a positive, co-operative relationship with investors (Ehrlich et al. 1994). VCs can provide a variety of non-financial benefits: for example, they can act as a sounding board, business advisor, financier, mentor/coach, friend/confidante, can provide its portfolio firm with access to various networks (e.g. be a source of industry contacts or professional contacts) and help recruit additional resources to the venture (Sapienza, Manigart, and Vermeir 1996). Ehrlich et al. (1994, 69) argue that: ‘who the entrepreneur gets his/her money from is just as important as how much capital is obtained initially’. It is, however, not certain that a VC will actually deliver all or any potential non-financial benefits. It is assumed that advisory firms have knowledge and experience on how to find the most appropriate VC for a specific venture and can aid in developing material for approaching the VCs.

First contact and screening

VCs reject most of the business plans that they receive primarily because a detailed evaluation of the business proposals requires a great deal of time and effort (Tyebjee and Bruno 1984). VCs therefore only undertake a detailed analysis of the most suitable plans that meet their own individual criteria. VCs specialise in terms of industry sector, stage of development and geographical location (De Clercq et al. 2001). Therefore, it is essential that entrepreneurs undertake research in advance to identify VCs that are the most likely potential candidates for investing in their venture. According to US data, VCs may spend only minutes making the first go/no-go decision (Hall and Hofer 1993). Therefore, the correct approach of entrepreneurs for contacting a potential VC is essential. In addition, VCs may also share information and, therefore, one VC’s decision to reject a business proposal may negatively influence a venture’s future possibilities of acquiring funding from any other VCs (Bygrave 1987). Consequently, entrepreneurs have much to lose in their first discussions and contacts with VCs. The entrepreneur’s main target is to survive
the VC’s first ‘rejection’ round and advance into more detailed discussions with VCs. It is expected that advisory firms can coach the entrepreneurs for the first meeting and aid the entrepreneur in the oral presentation of the business plan.

Negotiation and contracting

When VCs have ensured that the entrepreneur’s business proposition fulfils the VC’s specific investment criteria (e.g. stage, industry, geographical location) and the management is perceived to be sufficiently credible, VCs will start to analyse the venture in greater detail (Fried and Hisrich 1994; Shepherd 1999). If, after this phase, VCs still consider the venture to be promising, then the VC and the entrepreneur will start negotiating the terms of a possible investment. VCs are professional dealmakers and negotiators of contracts, while entrepreneurs in turn are often inexperienced in acquiring VC funding. Therefore, entrepreneurs commonly have substantially less knowledge to draw upon, in negotiating with a VC the price and terms and conditions of a deal (all of which can be very complex), and drawing up the shareholder agreement which may contain covenants that are not easy to understand (Kaplan and Strömberg 2003). This involves the risk that liabilities may materialise years after signing the contracts.

During the evaluation and negotiation period VCs carefully analyse the chemistry between entrepreneurs and themselves. A good relationship between the parties is essential because they commonly have to work together for years to develop the venture (Cable and Shane 1997). Moreover, entrepreneurial firms do not tend to have a long credit and operating history. This means that VCs cannot always rely on traditional tools for company analysis – the financial and operating history – being available. As a consequence, the key focus is on the assessment of the capabilities of the entrepreneur and the management team (Fried and Hisrich 1994). It is important for entrepreneurs to negotiate as good a deal as possible, while ensuring that they can build up a co-operative relationship with the VC. As this might be very difficult, it may require special skills and personality. Entrepreneurs can potentially either gain or lose massively on signing investment agreements with VCs. According to Hsu (2003), early stage entrepreneurial firms’ valuation is greatly dependent on the negotiation process with VCs, since early stage firms often lack tangible evidence that could help them defend their valuation of the firm. It is assumed that advisory firms can contribute to improving the valuation and contracting terms of entrepreneurs through participating in the investment negotiations.

Methodology and data

This study utilises the multiple case study approach, involving in-depth interviews with Finnish advisors, managers in VC firms and entrepreneurs. The in-depth interviews contributed to assembling detailed information on the actions of the advisors in the different phases of the process of acquiring VC funding. One of the strengths of this study is that all the advisors’ descriptions of their roles and value-adding functions are compared with the views of both entrepreneurs and VCs.

The advisory firms (i) are affiliate members of the Finnish Venture Capital Association (FVCA); and (ii) provide venture capital advisory services for entrepreneurs. There were six suitable advisory firms at the time when the interviews were conducted. Five interviews were completed, in each case with either a senior
partner or a managing director. It is worth noting that law firms, independent consultants, investment banks and large management consulting firms may provide at least some advisory services for entrepreneurs that are similar to those of the case companies. They are, however, excluded from the study for the following reasons. First, even though almost all major law firms are affiliate members of FVCA, it can be presumed that law firms provide only a fairly limited amount of advice for entrepreneurs, concentrating on legal aspects of the transaction and, therefore, they are less likely to be a source of advice for entrepreneurs regarding other important aspects of the transaction. Second, most likely there are various independent consultants who are providing advisory services for entrepreneurial firms regarding VC funding. Unfortunately, it is very difficult to locate these individuals and they are, therefore, excluded from the study. In addition, independent consultants are not members of FVCA, which was one of the preconditions for selection of the case companies. Third, large management consulting companies (such as Deloitte & Touche, Ernst & Young, KMPG and PricewaterhouseCoopers) were excluded from the study, even though they are members of FVCA, because these ‘big four’ consulting firms primarily target fairly large customers, while this study is interested in the role of advisors of entrepreneurs of innovative, young, growth-oriented firms that acquire VC funding. Table 1 summarises the operating procedures of the five advisory firms interviewed in this study.

The advisory firms were asked to name entrepreneurs for whom they had served as an advisor in the acquisition of VC funding and also VC managers they had approached in acquiring funding for their customers. Three entrepreneurs were interviewed, to obtain knowledge on how entrepreneurs perceive the role of advisors. One of the ventures had newly been founded when involving an advisor, whereas the other two had been operating for three and nine years. The characteristics of the entrepreneurial ventures participating in this study are summarised in Appendix 1.

At the end of the interviews the entrepreneurs were asked whether they were willing to refer the name of the VC fund manager that was responsible for making the investment decision. The objective was to obtain data on both parties to the dyadic relationship in order to get a more accurate picture of the role of advisors. By asking both the advisors and entrepreneurs to refer names, four VC fund managers were identified and interviewed for this study. Three of the four VC funds are members of FVCA. Two of the VC funds have a seed, start-up and early stage focus, whereas the other two are mainly concentrating on expansion funding. The interviews with the entrepreneurs and VC managers were conducted after having interviewed the advisors.

The study was initiated by pilot-interviewing a prominent lawyer and managing partner of a law firm that offers services for both entrepreneurs that acquire VC funding and VC firms. The main purpose of the pilot interview was to test a semi-structured interview protocol and to ensure that the research approach was relevant from the industry professionals’ point of view. As a result of the pilot interview some changes were made to the interview protocol. The interviews with advisors were conducted in three phases. First, all five advisor firms were interviewed. Each interview lasted between one and one-and-a-half hours. Then a follow-up interview was conducted with two of the advisors in order to fill some gaps in the initial research design. The length of each of the two interviews was approximately half an hour. Thereafter, the entrepreneurs and VC managers were interviewed. The length
Table 1. Advisory firms’ operating procedures.

<table>
<thead>
<tr>
<th>Employees</th>
<th>Alpha</th>
<th>Beta</th>
<th>Gamma</th>
<th>Delta</th>
<th>Epsilon</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cases evaluated/executed per year</td>
<td>12 projects are evaluated and 6 deals handled per year</td>
<td>Beta conducts 2–3 ‘full’ cases per year and some partial projects</td>
<td>Approximately two cases per year</td>
<td>20–30 cases evaluated and approximately 10 cases per year</td>
<td>Under 10 cases handled per year</td>
</tr>
<tr>
<td>Charging bases</td>
<td>Retainer and success fee</td>
<td>Retainer fee (e.g. €20,000) and success fee (e.g. 3% of the deal)</td>
<td>Retainer fee (e.g. €10,000) and success fee (e.g. 2–3% of the deal)</td>
<td>Retainer and success fee. In more risky cases, more emphasis on the retainer</td>
<td>Retainer and success fee</td>
</tr>
<tr>
<td>Operating procedure and services offered</td>
<td>Assists entrepreneurs in building verified business plans, participates in discussions with VCs and contacts VCs; does neither offer legal services nor help the entrepreneur to select the best possible match between partners</td>
<td>Helps to shape strategy, writes business plans, searches for a suitable investment candidate, participates in investment meetings and leads investment negotiations (also from legal perspective)</td>
<td>Writes business plan for entrepreneurs and explains what VCs’ documents actually mean for entrepreneurs; does not offer full legal consulting</td>
<td>Does not help entrepreneurs write business plans, helps in contacts with VCs and in due diligence (DD) process, uses external lawyers and provides detailed information on VC operating procedures</td>
<td>Turns VC process upside down and makes VCs compete against each other (also in start-up deals); Epsilon’s role is reduced after term sheet has been received</td>
</tr>
<tr>
<td>Client acquisition strategy</td>
<td>No active marketing: Alpha suggests it is very difficult to market/sell advisory services credibly</td>
<td>No active marketing, deal flow through networks such as universities’ research labs, research institutes and patent offices</td>
<td>All clients have been advisor’s existing customers from other projects</td>
<td>No active marketing</td>
<td>No active marketing</td>
</tr>
<tr>
<td>Alpha</td>
<td>Beta</td>
<td>Gamma</td>
<td>Delta</td>
<td>Epsilon</td>
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<tr>
<td><strong>Value added for clients (i.e. entrepreneurs)</strong></td>
<td>Write credible business plan, coach on how VCs operate Surprisingly: no impact for (1) valuation; (2) match between VC and entrepreneur; or (3) terms offered by VCs. According to Alpha, the firm does not really certify its customers for VCs</td>
<td>Assurance for entrepreneurs that their business is in good hands, faster process, better terms, valuation and elimination of risks and unfair terms and, finally, informal discussion channel with VCs, which may help and speed up the process</td>
<td>Better valuation due to increased competition among VCs, better match between VCs and entrepreneurs, improves the quality of the material by writing business plans (believes that entrepreneurs often prefer to concentrate on business not to write business plans)</td>
<td>Negotiates with VCs on difficult subjects and limits the risk of bad relationships between VCs and entrepreneurs, explains in detail what it means to get a VC investor, identifies the most suitable VC for entrepreneurs</td>
<td>Improved valuation and terms due to competition among investors Surprisingly: does not continue advising after the term sheet has been received (note that term sheet is a non-binding document)</td>
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<td><strong>Typical client</strong></td>
<td>Prefers Finnish industrial firms that need finance to grow and sometimes start-ups</td>
<td>Production company or research-intensive technology firms that are searching for growth funding; to a lesser extent early stage firms</td>
<td>IT-related clients with some turnover but sometimes even a firm with only an idea; normally acquired capital is 0.5–2 MEUR</td>
<td>Small deal size for Delta is 5–20 MEUR without any industry focus</td>
<td>No special industry focus, typically larger firms but in special cases also start-ups</td>
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<tr>
<td><strong>Business angel funding</strong></td>
<td>No advisory services regarding business angels due to small deal size</td>
<td>Business angels have high potential and those investment rounds can be faster</td>
<td>Very rarely since Gamma has only limited contacts with business angels</td>
<td>Business angel deals are too small</td>
<td>Business angels deals are too small</td>
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of these interviews varied from 20 to 40 minutes. All the interviews were recorded and transcribed.

According to Yin (2003), there are at least three general strategies through which to present case study findings: relying on theoretical propositions, rival hypothesis, and descriptive case illustration. This paper will utilise the third option, since the approach is rather explorative in nature by virtue of the lack of previous research on the topic. Therefore, the case study findings are presented in the form of descriptive case illustrations. The first section describes the characteristics of the advisory firms and their compensation structure. Then, the presentation of the empirical findings follows the same structure as the literature review. The role of advisors is organised in the three stages: search for capital, first contact and screening and negotiation and contracting. Appendix 2 includes a case study protocol comprising the following phases: getting started, selecting cases, crafting instruments and protocols, entering the field, analysing the data, shaping propositions, enfolding literature and research closure. The protocol is inspired by Eisenhardt (1989).

**Case illustrations**

The five case companies are introduced in this section. The initial focus is on their operating procedures. In order to preserve their anonymity, the advisory firms are named using the Greek alphabet: alpha, beta, gamma, delta and epsilon. Some of the key findings are summarised in Table 1.

**Characteristics of the advisory firms and the compensation structure**

The advisors Apha and Epsilon were asked to define the advisory services they provide. They indicated that their services cover the entire process, from preparing and developing material for approaching VCs, to successfully closing the deal. In their view the process can be divided into two parts: the preparation aimed at increasing investment readiness and the assistance in dealing with the VC investor.

The five advisory firms are medium-sized and small consulting firms. Alpha is the largest firm with approximately 15 employees, while the smallest firms, Beta and Gamma, have fewer than 10 employees. Two of the advisory firms, Beta and Gamma, are relatively young, having been founded in 2002–03. The other three were founded in mid and late 1990s. In addition to helping entrepreneurs acquire funding, Alpha and Beta also focus on advising on M&A activities. Beta actively, and on rare occasions Gamma, help entrepreneurs acquire business angel funding. The three other advisory firms perceive the deal sizes, in business angel funding, to be too small to be considered as financially attractive (and that business angels are difficult to locate). This is because part of their remuneration is directly linked to the size of the deal. Alpha, Beta and Gamma are prepared to offer their services to smaller early stage firms, while Gamma and Epsilon prefer larger deals. Typical deal sizes vary among advisors. The smallest deals are less than €0.5 million (the amount of capital that entrepreneurs are acquiring), while the largest are over 100 times bigger. After screening out the least promising proposals, these advisors commonly handle fewer than 10 projects annually, although there is some variation around this figure. Whereas Delta handles approximately 10 cases per year, Beta and Gamma appear to handle only two to three cases per year.
Alpha and Epsilon only handle deals they see as sufficiently attractive to be candidates for VC funding. A part of advisors’ professionalism lies in the fact that they can relatively quickly determine the quality of the proposal. The quality is assessed in discussing the case with the entrepreneur and in performing appraisals of the business and the capabilities of the entrepreneur and the management team. In other words, the decision to choose or reject the proposal for advisory services builds on the analysis advisors undertake.

The compensation for the five advisory firms is based on a combination of a retainer fee and a fee that is charged when the advisor has succeeded in acquiring VC funding for the business. The retainer has to be paid by the entrepreneur whether or not the advisors are successful in acquiring funding. Alpha and Beta suggested that paying this kind of fee demonstrates an important commitment on the part of the entrepreneur. Beta reported that the size of the retainer is approximately €20,000, adding that this does not cover the project costs. This highlights the importance of achieving success. Gamma’s retainer is considerably lower than Beta’s, at €10,000 per client. Delta argued that the retainer is crucial when the cases involve high risk. The interviews revealed that a typical success fee is 2–3% of the size of the deal. Currently Beta has a success ratio of 100%, meaning that it has been able to secure funding for all its clients. Epsilon estimated that it has a success ratio close to 90%, while Alpha believed its success ratio to be at least 75%. The three entrepreneurs interviewed all felt that the compensation advisors charge for involvement is in line with the value of their services. One entrepreneur, however, strongly suggested that the advisors should demonstrate a firm commitment to the deal by tying their compensation to success of the deal instead of charging a high retainer.

The four VCs indicated that the entrepreneurs’ use of advisory services relates to the entrepreneur’s previous experience and know-how, the deal size and the time available for managing the process of acquiring VC funding. One VC pointed out that entrepreneurs who are aware of the costs and time involved in the process of acquiring funding might consider outsourcing this task. Another VC held the view that entrepreneurs with relevant experience may prefer to do it themselves. The use of advisors was seen to be more common among larger entrepreneurial ventures that have higher investment requirements. In large business acquisitions advisors are virtually always utilised. Based on the interviews, the key reason for entrepreneurs to involve advisors is the lack of time available for managing the process of acquiring VC funding. Two of the three entrepreneurs in this study had contacted an advisor for this specific reason. It is most likely less expensive to outsource the task to an advisor, a specialist with plenty of resources and most importantly contacts, than to employ personnel to the entrepreneurial venture for managing these tasks. In small entrepreneurial ventures in particular the entrepreneur’s human capital is crucial for the business. If much of the entrepreneur’s time is tied up in acquiring funding, the business activities may suffer and in the worst case the venture may not survive this process.

Alpha and Epsilon as well as the four VCs interviewed expressed their views on how the advisory services in Finland differ from those in more mature markets such as the US and the UK. The key difference seems to relate to market sizes. Alpha and Epsilon and one of the VCs argued that in the US and the UK there is more industry sector and case specialisation than in Finland. Foreign advisory firms are much larger than their Finnish counterparts, and therefore people that specialise in different business areas and industry sectors can be found within a single firm. In
addition, because the deals are generally larger in the US and the UK, the quality of the advisory services is likely to be higher. One of the VCs commented that since Finland is a small-scale market, many of the actors in the market know each other. Consequently, the matching of advisors and entrepreneurs is likely to be based to a large extent on word of mouth and established networks of contacts. The fact that two of the three entrepreneurs interviewed for this study chose an advisor that belonged to their network of contracts reinforces this argument. The VC added that this is, however, not the case in the US and the UK, where entrepreneurs contacting advisors often face unknown actors. Dealing with unknown actors increases the importance of collecting background information on the advisors.

The role of advisors in the VC investment process

This section focuses on the pre-investment phases in VCs’ investment process. It sheds light on how the advisors operate, and identifies the benefits and drawbacks from using advisory services. The three entrepreneurs and, surprisingly, all four VCs viewed the involvement of an advisor in a positive light. All three entrepreneurs perceived that the benefits of including an advisor outweigh the drawbacks. Furthermore, all of them would use an advisor again in a similar setting. The process from identifying a need for funding to the investment decision varied in length for the three entrepreneurial ventures from about one year to three years. All three entrepreneurs found that the involvement of an advisory firm helped to speed up the process. The evidence that the involvement of advisors is beneficial reflects the extensive expertise of the advisors. They seem to be capable of aiding entrepreneurs while simultaneously convincing the VCs. This study strongly indicates that they are appreciated.

Search for capital

Beta perceived that the credibility of the entrepreneur, in the eyes of VC firms, improves when he/she is focused on just one line of business. Consequentially, Beta may demand that entrepreneurs drop a business unit that is not a good fit within the scope of the venture. This can be seen as a radical demand, as a precondition for acceptance. Similarly, Alpha also encourages entrepreneurs to concentrate on the most promising business area or (geographical or physical) market, rather than having a very broad focus. Alpha noted that, as well as reducing an entrepreneur’s credibility among VCs, undertaking several business ventures (or projects), simultaneously, will also divert their focus from their core business activity. Beta sometimes makes changes in the operational business of its clients before approaching VCs, for example, in the financing structure or intellectual property rights policy of the firm. However, only one of the three entrepreneurs in this study indicated that their advisor had been involved in changing their business and/or revenue model. One of the VCs argued that the advisor should not have too strong a say on how the business activities are run.

The advisory firms feel they contribute to improving the investment readiness of the entrepreneurial venture. Their involvement in developing material that can be used when approaching the VCs increases the credibility of the investment opportunity and, hence, the likelihood of passing the initial screening phase. Alpha and Epsilon revealed that this is the part in the process for which most time is
allocated. The involvement of the advisors is, naturally, a function of the quality of
the material the entrepreneur has already developed. For Epsilon, between 10% and
50% of its time is consumed in participating in developing this material. For Alpha
the proportion is about 30%. Epsilon added that about 10% of its time is used in
getting acquainted with the entrepreneur. Delta suggested that most of the material
provided to VCs is developed by the entrepreneurs and that it only assists and
provides feedback. Even if a well-conceived business plan has been developed by the
entrepreneur, advisors most often need to revise it so as to make the key aspects
easily understandable for VCs. Epsilon commented that it examines the contents of
the plan thoroughly and revises it. Two of the four VCs emphasised that it is
important that the developed material reflects a strong understanding of the grounds
and criteria for VC decision making. One VC added that the higher the quality of the
material provided to the VCs, the faster an investment decision can be reached. All
three entrepreneurs reported that their advisors had participated in shaping the
format of the business plan. One of them remarked that he would have been too busy
to come up with this material.

Alpha reported that 20% of its time is taken up in discussions with the
entrepreneur. Together with the entrepreneur Alpha aims to address questions such
as: how much money should be sought, how will the involvement of VCs impinge
upon the ownership structure and how will the value develop at different stages? The
discussions will follow a timetable that has been established for the process of
acquiring funding. Beta often advises entrepreneurs on what to expect from VCs,
since entrepreneurs’ expectations are often unrealistic. Beta also pointed out the
importance of the communication channels that it has with VCs. Having direct
discussions with VCs enables it to effectively identify problems that might prohibit a
VC investment. For example, sometimes a VC has signalled to Beta that it does not
want to deal with a certain entrepreneur, prompting Beta to approach other VCs or
search for other financing options. According to Beta, it would be much more
difficult to establish such a direct dialogue between a VC and entrepreneurs. Beta
believed that a suitable VC can provide substantial non-financial benefits for
entrepreneurs and that bad decisions made by VCs can have very damaging effects
on the venture’s business. Similarly, Gamma suggested that entrepreneurs’
expectations regarding VCs might be unrealistic. Interestingly, most of Gamma’s
clients consider VC funding first, but when they learn more about the chances of
success in acquiring such funding and the kind of terms that VCs expect
entrepreneurs to commit themselves to, most entrepreneurs are unwilling to proceed
with VC funding. Delta also advises entrepreneurs on the operating procedures of
VCs. It notes that VCs’ way of thinking is often very difficult for entrepreneurs to
comprehend. Commonly, entrepreneurs are of the opinion that they are selling a part
of their company to the VCs, while the VCs think that they are founding a new
company and the entrepreneurs can participate in this new company.2 In some cases
Delta has invited family members of entrepreneurs to meetings where VCs explain
their normal operating procedures. Sometimes these events have led to the rejection
of VC funding and prompted the search for an alternative financing option. Delta
also advises entrepreneurs on how the VC deal might affect their personal financial
situation, notably in terms of the legal and taxation aspects. Epsilon indicated that
the operating procedures of VCs are addressed in their first meeting with the
entrepreneur, because entrepreneurs seldom have knowledge of VC investment
contracts and their role in an investment.
All three entrepreneurs felt that their advisors helped them to understand the operating procedures of VCs. One of the VCs agreed with Delta’s view that the crucial task of the advisor is to see that sensitive, ownership-related issues are addressed before approaching the VC. According to this VC, the pricing of a deal is based on certain well-known facts, and if the entrepreneurs’ lifetime work is not reflected in the numbers, the VCs’ valuation may diverge substantially from the entrepreneurs’. She added that an advisor must educate entrepreneurs on the operational procedures of VCs, so that no surprises emerge, and the entrepreneur is not disappointed because of unrealistic expectations. In summary, injecting realism appears to be the greatest benefit of involving advisors in the venture capital funding process.

In terms of non-financial benefits that VCs provide, Gamma tries to arrange as good a fit as possible between the entrepreneur and a VC. For example, in its current cases, the entrepreneurs would have preferred a Finnish VC but because of the nature of the business Gamma recommended that a VC located in Silicon Valley would be a better choice for the entrepreneurs. Delta stated that foreign VCs are becoming increasingly active in the Finnish market and are often more professional than Finnish VCs and thus commonly offer a superior funding source for its clients. Alpha, Beta and Delta belong to international advisor networks. Beta also highlighted the importance of finding the correct match between VCs and entrepreneurs. Because of the small size of the VC market in Finland, there are often only a few funding options. Thus, Beta sometimes searches for the best VC–entrepreneur match on a global scale by approaching foreign VCs or by participating in foreign matching events where VCs and entrepreneurs meet each other. Epsilon stated that its main value is that it actively makes VCs compete against each other for the investment in its client company. For example, the standard negotiating period of 45 days that VCs demand is something that Epsilon tries to avoid. Instead of agreeing to provide one VC with exclusive rights to negotiate a deal, competition can be created, in both smaller and larger deals, when the investment opportunity is sufficiently attractive.

All the three entrepreneurs confirmed that their advisors helped in them in selecting the VC. Two entrepreneurs also indicated that their advisors helped them in contacting industrial investors as well. As the VCs are well known to the advisors, approaching VCs is not a time consuming task for them. Alpha reported that at most 5–10% of its time is accounted for in approaching VCs. However, Epsilon estimated that approaching VCs and making them compete with each other accounted for 20–30% of its time. Making VCs compete for the deal may result in an increased valuation of the entrepreneurial venture. This aspect will be revisited in the negotiation and contracting discussion.

First contact and screening

If the VCs’ response to their initial screening is positive they will normally then want to meet the entrepreneurs (De Clercq et al. 2006). This meeting is often referred to as the ‘pitch’. Alpha’s partners usually present the entrepreneur’s story to the VCs. Alpha believed that its participation in the pitch increases the credibility of the venture. This is because Alpha has its own reputation to protect and, therefore, does not present cases to VCs that it does not believe are sufficiently attractive to qualify for VC funding. In contrast to Alpha, Beta does not want to take an active role in the
pitch. Beta advocated that it is more important that entrepreneurs present the case to VCs. Beta’s partners understand the phases in the VC investment process and can tell the entrepreneur(s) beforehand what to expect from VCs. This provides security and assurance for entrepreneurs. Two of the three entrepreneurs felt that the advisor had coached them for the pitch, while one perceived that he did not need the coaching. Alpha and Epsilon argued that they do not specifically coach entrepreneurs for the pitch. In their view coaching is continuously ongoing from the first meeting with the entrepreneur. Alpha added that the entrepreneurs should present themselves as they are.

Epsilon reported that its good track record is based on a deep understanding of the VC investment process. The key is to acknowledge the fact that VCs do not actually make investment decisions by themselves. They simply present the most interesting investment opportunities to their investment committees where limited partners sit. If entrepreneurs are able to provide material (with the help of advisors) which is good enough for the VC to utilise for his/her presentation to the investment committee, the chances that the VC will proceed with the investment opportunity are increased. This limits the work required of the VC and increases the chances of a positive investment decision. Before the first meeting the VC is usually provided with a summary of the business plan. This presentation is ‘blind’, meaning that the identity of the entrepreneur is concealed. Epsilon strongly suggested that the rest of the material is only submitted if the VC provides an ‘indication of interest’.

In the interviews it was highlighted that entrepreneurs often only have one chance of convincing a VC of the quality of their investment proposal. If that attempt is unsuccessful it may be very difficult to convince the same VC on a subsequent occasion. Entrepreneurs’ learning is particularly important in small VC markets such as the Finnish one where there are only a few VC firms that can provide funding for a particular entrepreneurial firm. In such contexts it is important that entrepreneurs do not spoil their chances of acquiring funding by taking the wrong approach. Beta highlighted that its feedback is highly important for the entrepreneurs as it educates them on how to approach VCs, for example, emphasising that high growth, the entrepreneur’s aspirations and chemistry between the investor and the entrepreneur are critical investment criteria of VCs (Ruhnka, Feldman, and Dean 1992; De Clercq et al. 2006).

All the entrepreneurs confirmed that their advisors participated in the investment meetings. The VCs felt that the advisors’ involvement has both positive and negative effects on the credibility of the deal. On the one hand, advisors have performed some kind of screening and investment analysis and therefore these deals have been pre-screened. As noted earlier, advisors select as clients only those companies that they believe have sufficient potential to qualify for VC funding. On the other hand, the most capable entrepreneurs do not need advisors to undertake these tasks. If the VC believes that it is the advisor that has prepared most of the material needed for approaching the VC this will have a strong negative impact on the entrepreneur’s credibility. If the entrepreneur is overshadowed by the advisor in the discussions, this will also damage the credibility of the entrepreneur. Two VCs noted that the entrepreneur is treated differently when an advisor is involved. In such situations the VCs are more vigilant, taking care to ensure that the advisors do not strive to fulfil their own agendas in presenting the case to VCs.
Negotiation and contracting

Alpha adopts a fairly pessimistic stance on the possibility that its participation will increase the valuation of the venture. Accordingly to Alpha, VCs are not willing to negotiate valuation but make their offer and entrepreneurs can either reject or accept it. After the pitch, VCs prefer to continue discussions with the entrepreneurs without Alpha’s presence, as VCs want to ensure that there is chemistry between them and the entrepreneurs. Therefore, Alpha’s responsibilities diminish and the process unfolds. Alpha does not provide legal advice on the investment and shareholder agreements. Alpha recommends that law firms should be involved in drafting the contract, suggesting that its own role in the negotiations is to comment on what it perceives as fair. Consequently, Alpha estimated that only 10% of its time is allocated in negotiations with VCs.

Both Beta and Epsilon highlighted the benefits of having VCs compete over a deal. Beta’s aim is to create a situation where a VC is either competing with another VC or the venture has some other means to finance its business. This contest between investors often improves the chances of acquiring funding, and improves terms while also decreasing process time. Epsilon explained that in one management buyout deal in which it participated, the valuation doubled during the competition. For Beta the competition has the effect of reducing the exclusivity period of negotiations from 45 days to 30 days. This means that entrepreneurs can approach another VC two weeks earlier if negotiations are not successful with the current VC. Two VCs saw the advisors’ role in increasing the competition for a deal in very different light. One VC felt that this is one of the key advantages that entrepreneurs obtain, whereas another VC thought that this is one of the key drawbacks brought by the involvement of advisors. This VC claimed that he prefers to talk to the entrepreneur exclusively, instead of having to participate in a race. For Epsilon between 10% and 20% of the time in the process of acquiring funding is consumed in negotiations.

In contrast to Alpha, which recommends the involvement of law firms to advise on valuation and investment agreements, negotiations are an essential part of Beta’s operating procedures. Entrepreneurs are commonly present at these negotiations but do not necessarily understand what is discussed between a VC and Beta. In Beta’s opinion, an advisor can only effectively advise its clients if it has participated in dozens of investment negotiations and also has experience of how agreements have materialised in practice, years after being signed.

Delta’s role resembles that of Beta. It participates in the investment negotiations and the pitch but uses law firms to draft legal contracts between the VC and the entrepreneur. Delta pointed out that investment negotiations between a VC and an entrepreneur can sometimes be very aggressive and tense. In these cases, a skilful advisor may be able to take most of the blame on his/her shoulders, which should ensure a better and more positive post-investment relationship than would be possible in bilateral negotiations between a VC and an entrepreneur. According to Gamma, entrepreneurs specifically expect their advisors to translate what VC contracts mean in practice. Gamma reported that entrepreneurs must be made familiar with the VC investment process because VCs may take advantage of entrepreneurs’ inexperience by negotiating deals with unfair contract terms. Entrepreneurs are used to procedures where contracts that are offered by one party aim for a fair deal, and that the contracting parties do not try to take advantage of the inexperience of another party, as is sometimes the case in VC deals. In addition,
according to Gamma, a VC may offer investment terms that they call standard terms, non-negotiable, when in reality there is a lot of scope and freedom to negotiate. Beta suggested that because of their lack of experience entrepreneurs may agree to enormous contractual penalties and other unfair terms without carefully considering or even understanding what they are agreeing to. Contrary to Beta, Delta and Epsilon, Gamma did not believe that its participation dramatically increases the valuation of a venture that one specific VC offers, but held the view that an advisor may be of help in contacting another VC that can offer a better valuation. Gamma’s experience suggested that VCs’ valuations can vary by more than 100%. Gamma also believed that it can negotiate considerably better terms from VCs than entrepreneurs alone are able to. None of the three entrepreneurs believed that the advisor managed to increase the valuation of their venture, but they all agreed on the advisors’ contribution to improving the entrepreneurs’ terms in the deal. Two of the VCs explicitly mentioned that it is important that the advisors do not attempt to increase the valuation for the sole purpose of aiming at increasing their own profits. One of the VCs stated that it is important that the involvement of an advisor does not relate to an immediate increase in the proposed valuation. This would imply that the VC is paying the advisor’s bills.

VCs suggested that there are both drawbacks and benefits from the involvement of advisors in negotiations between entrepreneurs and VCs. One VC felt that the involvement of advisors might prolong negotiations, whereas another VC felt that their involvement can reduce the duration of the negotiations. If entrepreneurs are unfamiliar with how to negotiate a deal, advisors can clarify the deal terms and achieve a better bargaining solution. However, if the advisor is very active in negotiating the deal, he is taking the driving seat, appearing to be the brains behind the business. Two VCs emphasised that the advisor should not make decisions on behalf of entrepreneurs. The advisor can make clear what alternatives are available, but the entrepreneur has to make the decision regarding which alternative to choose. Thus, it is important for the entrepreneur and the advisor to decide from the outset how the responsibilities shall be divided between themselves. According to one VC, there is much individual variation in their role in negotiations. If the entrepreneur is unfamiliar with how negotiations are conducted, the gain from using advisors can be substantial. Some entrepreneurs do need the involvement of advisors to negotiate deal terms. Advisors may help the entrepreneurs in locating lawyers and accountants. Two of the entrepreneurs indicated that advisors had aided them in locating these experts, while the third entrepreneur stated that he did not need the advisor’s help, as he had his own lawyers and accountants.

One of the entrepreneurs heavily criticised the terms in VC funding. He advocated that the terms and valuations of VCs are unreasonable, adding that VCs expect to see a 30%, 40% or even 50% annual increase in the value of the firm. Even for profitable companies that have overcome the valley of death, such growth is difficult to achieve. According to this entrepreneur, only entrepreneurs that desperately need funding are willing to accept such terms. The fact that VCs often see entrepreneurs’ valuations as unrealistic, while entrepreneurs see VCs’ valuations as unreasonably harsh, makes the advisor’s job difficult but highly important. None of the entrepreneurs had any disagreements with the advisory firm.

The VCs were asked to report on the percentage of their deal flow in which an advisor participated, and on the percentage of deals involving an advisor that obtained funding. Three of the four VCs interviewed for this study provided...
estimates for these ratios. One VC, which focused mainly on later stage investments and management buyouts, suggested that an advisor of some kind is always involved in the deals. The others, with a more entrepreneurial investment focus, reported that 20% and 30% respectively of their deal flow involved an advisor and that 30% and 50% respectively of the firms that have used an advisor obtained funding. In addition to the high success ratios of advisors, the fact that the proportion of cases with advisor involvement is higher for the cases which raised finance than for deal flow in general points to the benefits to entrepreneurial ventures from the involvement of an advisor.

**Discussion**

This study concentrates on the role of advisors in the VC investment process which is an aspect of the investment process that has been largely overlooked. The aim of the paper has been to develop an understanding of the operating procedures of Finnish advisory firms and the benefits and drawbacks of advisor involvement for entrepreneurs looking for VC funding. Five advisors, three entrepreneurs that have utilised advisors in acquiring VC funding and four VCs that have negotiated deals where advisors have been present at the investment meetings were interviewed for this study. In this section we evaluate the advisors’ role in the different stages in the process of assisting entrepreneurs acquire VC funding.

The advisors only select as clients firms that they believe have sufficient potential to attract VC funding. In order to ensure that a venture has the necessary potential to raise VC, advisors first have a discussion with the entrepreneur about the investment proposal and perform an investment analysis. Advisors have their own reputation to protect and so they want to retain a good track record, reflected in their success rate (the percentage of their clients that have obtained VC funding). The high success ratios of the Finnish advisory firms is evidence for their expertise in evaluating and selecting proposals and in dealing with VCs. Advisors’ revenue comes from two components: a retainer fee that entrepreneurs pay regardless of whether the project is successful or not, and a success fee, typically 2–3% of the funds that are acquired. Since the deal sizes generally exceed €1 million and the largest deals exceed €20 million, the success fee is usually significantly greater in magnitude than the retainer. This means that advisors’ pay is to a great extent performance based, dependent upon advisors’ ability to successfully close the deal.

When the advisor has decided to undertake a project and the entrepreneur has agreed to pay the fee, the first task is to improve the investment readiness of the entrepreneurial venture. This was considered to be one of the most time consuming tasks and also a very important benefit that the advisors provide. This saves the entrepreneurs valuable time that they need for running their business operations. Moreover, most entrepreneurs may not be able to clarify the key dimensions of their investment proposal in a manner that satisfies the VCs. Advisors review and revise the contents of the business plan so that VCs easily understand what the entrepreneur is selling and potential of the business. The quality of the material should be sufficiently high for the VC to take to their investment committee. Advisor involvement addresses crucial deficiencies in the entrepreneur’s business. High quality material should increase the probability that a VC will actually proceed with the project and that entrepreneurs will eventually get a positive investment decision.
from the VC. This study suggested that many of the entrepreneurs have neither the
time nor the necessary expertise to come up with material that convinces the VCs of
the potential of their business as an investment opportunity.

Advisors also have a crucial role in educating the entrepreneur on the VCs’
investment procedures. Entrepreneurs should be made aware of what involving a VC
implies at the stage when they are preparing their investment documentation. VCs
felt that it is essential that sensitive issues relating to ownership are addressed as early
as possible. If entrepreneurs and VCs have divergent views regarding the value of a
firm this is likely to be one of the key deal breakers. VCs considered that advisors
add realism by educating entrepreneurs on contractual terms and investment
instruments. When entrepreneurs learn about VCs’ investment procedures, some will
abandon seeking VC funding and ask their advisors to find alternative funding. This
is because entrepreneurs may take the view that the conditions for obtaining VC
funding are overly onerous. For example, they may not be willing to relinquish a
substantial share of the ownership and agree on the inclusion of penalising
contractual covenants in exchange for the invested capital.

Advisors can also recommend which VC an entrepreneur might approach.
Advisors have expertise in evaluating which VC provides the best possible match for
a specific entrepreneur. Foreign VCs are suggested when they are seen as more
suitable partners than any of the domestic ones. Many advisors belong to
international advisor networks, and some search for an optimal VC partner through
participation in foreign matching events. Since the Finnish venture capital market is
small scale, approaching foreign VCs increases the amount of potential candidates
for VC funding. It appears that competition among VCs for funding has the positive
effect of improving entrepreneurs’ deal terms and increasing the valuation of the
venture. Clearly, having VCs compete for a deal presupposes that the investment
opportunity is sufficiently attractive and that there are several VCs that match the
entrepreneurs’ investor preferences.

From a VC’s perspective, advisor involvement may increase or decrease
credibility of the investment opportunity. The fact that investment opportunities
involving advisors have already been screened and analysed by an advisor tends to
increase credibility. Nevertheless, if the investment documentation that has been
prepared appears to be the work of the advisor, and the entrepreneur’s input can be
called into question, this might have the adverse effect of decreasing credibility.

If the entrepreneurial venture survives the initial screening, the VC will want to
meet the entrepreneur. In this first meeting, referred to as the ‘pitch’, the
entrepreneur’s story is presented to the VC. Some advisors participate in the pitch
and see this as beneficial for the deal, while other advisors perceive that it is better
that the entrepreneur presents his/her story, with the advisor’s role limited to
instructing the entrepreneur on how to present. None of the advisors advised their
clients on what to avoid when presenting their case to VCs. From the entrepreneurs’
point of view, this could definitely be an area for improvement in advisors’ operating
procedures.

The involvement of advisors in contractual negotiations depends to a great extent
on how familiar the entrepreneurs are with the terms and procedures. In general, an
entrepreneur searching for VC funding does not understand the consequences of
investment agreement clauses, such as liquidation preference clauses and vesting
clauses. In addition, according to advisors, VCs often claim that the terms they are
offering to entrepreneurs are industry standards, which are non-negotiable.
However, that may not be true and in reality almost anything is open for discussion. All of the entrepreneurs perceived that the involvement of advisors had improved the terms of the deal. In most cases advisors preferred to include lawyers to handle the task of drafting the contract. Entrepreneurs considered that the advisors helped in locating lawyers belonging to their network of contacts.

VCs remarked that advisors should not take a too active role in the negotiations and investment meetings, as this would imply that advisors have their own agendas. This issue is particularly germane when advisor involvement relates to an immediate need to increase the valuation when VCs may interpret this as an attempt by the advisor to increase their fee from the assignment. VCs often want to meet the entrepreneurs separately, in order to make sure that there is chemistry between them and entrepreneurs. Nevertheless, situations also arise when a VC wants to discuss a matter with the advisor without the presence of the entrepreneur. Then, value is found in establishing a direct discussion channel between the entrepreneur and the VC. Consequently, advisors may eliminate disputes among VCs and entrepreneurs by handling difficult issues in the negotiations, enabling the formation of a fruitful post-investment relationship.

In sum, as all the entrepreneurs and VCs viewed the involvement of advisors in a positive light, this strongly suggests that advisors’ involvement has benefits for entrepreneurs looking for VC funding. In this study the advisors appeared to accelerate the process of acquiring VC funding by improving the investment readiness of the business, approaching VCs and providing assistance and feedback in investment meetings and negotiations. Their involvement also improves the terms of the deal and sometimes the valuation. Furthermore, advisors’ assistance can aid in selecting VCs that deliver non-financial benefits, through engaging in various value-adding roles post-investment (Ehrlich et al. 1994; Sapienza, Manigart, and Vermeir 1996). The main disadvantages are that it may take time to locate a suitable advisory firm; advisors charge a retainer that has to be paid even in the case of failure; advisors may have too strong a say on the venture’s operations and in some cases overshadow the entrepreneur in the meetings and negotiations. Contacting VCs without advisors is only appropriate for entrepreneurs that have extensive prior experience of VC funding. For other than very experienced entrepreneurs, it may be difficult to negotiate a good deal with VCs, and VCs may utilise their superior negotiating and deal structuring knowledge against entrepreneurs (Starr and Bygrave 1991; Hsu 2003).

**Conclusion**

This study has taken a rather practical approach to analysing the role of advisory firms in the VC investment process from the entrepreneurs’ perspective. However, the study can be linked to several theoretical concepts in the VC research. First, this study adds to the literature on ‘investment readiness’, highlighting the importance of ensuring that there are no shortcomings in the written and oral presentations, when applying for VC funding (e.g. Mason and Harrison 2001, 2004). The data in this study demonstrate that the quality of the material provided to VCs is crucial. More complete information reduces information asymmetries with the effect of increasing the likelihood of qualifying for funding. Likewise, the role of advisors in educating entrepreneurs about VC investment procedures reduces asymmetric information, as entrepreneurs become aware of the ‘tricks of the trade’.
Second, it has been acknowledged that it is very difficult to analyse the quality of entrepreneurs and their venture (e.g. Amit, Glosten, and Muller 1990). Because it may be difficult for VCs to directly evaluate investment candidates they may have to rely on signals (Megginson and Weiss 1991). Consequently, as argued earlier, VCs may perceive the involvement of qualified advisors – whose compensation is based on the successful acquisition of VC funding (both long-term and short-term compensation) – to be a signal that the investment opportunity is of high quality. The findings therefore suggest that advisors often certify entrepreneurs’ business proposals. This means that the likelihood that the entrepreneur will be successful in acquiring funding and obtaining better valuation and/or investment terms improves when advisory firms are involved in the process. The fact that advisors often conduct their own due diligence before they decide whether or not to accept entrepreneurs as their clients supports the assumption of the signalling effect. Therefore, as suggested previously, advisors may in effect ‘pre-screen’ the firms on behalf of VCs.

Third, the advisors in this study sometimes developed the strategy and business model of their clients prior to approaching VCs. The main idea is to deliver focused, consistent and credible business proposals to VCs. However, the amended business model is not something the entrepreneurs have developed themselves. Therefore, there may be a risk that entrepreneurs are not fully behind the business model suggested by advisors. The strategy may increase the chances of acquiring VC funding, but at the same time the entrepreneurs might still be considering whether to continue with the earlier strategy. Consequently, the venture may develop, after the investment has been made, into something other than what the VC expected. This risk is in agency theory referred to as adverse selection, due to asymmetric information (Amit, Glosten, and Muller 1990). In other words, a skilled and motivated (by the success fee) advisor might increase the risk of adverse selection by ‘window dressing’ the venture in line with the VCs’ expected decision criteria. Moreover, as noted previously, the business plan and strategy may reflect a skilful advisor rather than a skilful entrepreneur. However, advisors are looking for more than a single deal. They aim to build long-term business, which is likely to require approaching the same VCs on a frequent basis. Offering these investors low quality investment opportunities would lead to them rejecting subsequent opportunities presented by that particular advisory firm. For these reasons a ‘short-term window dressing strategy’ is unlikely to be sensible. However, it would be interesting to compare strategies and strategy changes between entrepreneurs that have acquired VC funding with and without advisors.

Fourth, the resource-based view, which has been applied in the VC–entrepreneur context, concentrates on the resources that are scarce, difficult to imitate or substitute, and valuable to the success of a firm (Barney 1991; Manigart et al. 2002). In the VC–entrepreneur context it can be argued that VCs provide resources such as capital, experience, access to networks and credibility for the entrepreneurs, and entrepreneurs provide the chance to participate in an unexploited and potentially profitable business opportunity. It would be very difficult for the entrepreneurs to succeed without VCs, and obviously without entrepreneurs VCs would not exist. Relevant in the resource-based view and this study on advisors are (i) the identification and analysis of required resources from both entrepreneurs and VCs; (ii) the selection of the most suitable partner according to those needs; and (iii) the assurance of the transfer of required resources during the post-investment phase. The identification and analysis of required resources relates to the inexperience of
entrepreneurs with regard to VC funding. Entrepreneurs may not be able to identify and analyse the gaps in their business and they might not know how VCs can provide contributions to these deficiencies. The second point, selection, relates to the fact that VCs are not all alike. They vary for example in terms of the industries they invest in, the stages of the firms that they invest in, their involvement level, reputation and experience (Ehrlich et al. 1994). Consequently, advisors who have negotiated and been involved with the same VCs before may be able to select the most suitable partner for a specific entrepreneur in a way that matches the entrepreneur’s needs and the VC’s resources. Third, even though VCs possess the resources that are needed by the entrepreneurs, the delivery of these resources is not obvious. It may be more profitable for the VCs to allocate their resources differently from what is optimal for the entrepreneurs (Sahlman 1990). Therefore, an interesting question is: could an advisor increase the likelihood of selecting VCs that are more likely to possess and also provide the critical resources for the entrepreneurs? One way might be through making sure that the shareholder agreements that are drafted between VCs and entrepreneurs also serve the best interests of the entrepreneur. VCs should be expected to contribute to the relationship after the capital has been infused.

In drawing to a close, it is important to acknowledge the limitations of the study. There are alternative sources of advice that entrepreneurs could utilise, such as specialised management consulting firms, investment banks, business incubators, government organisations, universities, law firms and private individuals. However, this research project has concentrated on the most specialised source of advice and information for entrepreneurs and, hence, those other sources are excluded. They could provide additional information about the different options available to entrepreneurs when searching for advice.

The study has therefore provided initial insights to a highly important research area that undoubtedly deserves more attention in future research within the domain of venture capital. However, 20 years ago Stevenson and Sahlman (1988) had already called for more attention to be given to how small firms should manage their relationships with advisors. This study repeats these scholars’ call – the role of advisors is too significant to be neglected.

Finally some limitations need to be acknowledged. In this study five of the six specialised advisory firms were interviewed. However, this study includes only three entrepreneurs that have used advisory services and four VCs that have experienced the involvement of advisors in deal negotiations. Therefore, there might be entrepreneurs and VCs that do not share the views of the ones interviewed for this study. Another limitation is that only entrepreneurs who had managed to acquire funding were interviewed for this study. This is because it would have been extremely difficult to identify (the few) unsuccessful cases. In interpreting the research findings of this study, it is therefore important to bear in mind the limitations of case studies with respect to generalisability. As Yin (2003) points out, multiple cases should be seen not as sampling units, but rather as multiple experiments. This study is conducted in Finland, a small-scale market for venture capital, where there was a highly limited number of specific advisors to approach for interviews. There is a need for quantitative studies examining the role of advisors, in more developed markets, such as the US and the UK. These studies could investigate how the characteristics of the advisory firms and entrepreneurs influence the involvement of advisors in the process of acquiring funding as well as the perceived advantages from using these services.
Acknowledgements

The authors wish to express their gratitude to Dr Marjo-Riitta Parzefall and to the participants of the ISBE conference in Cardiff in November 2006 for their comments and encouragement on earlier versions of the paper. All errors and inconsistencies are ours.

Notes

1. For example, VCs do not always agree to sign non-disclosure agreements (NDAs) with entrepreneurs, which may surprise some entrepreneurs (e.g. Cable and Shane 1997; Meredith 2004).
2. This often occurs also in practice as a way in which a VC can avoid some liabilities of existing companies.
3. This statement is not consistent with previous research (see e.g. Zacharakis and Meyer 1998) highlighting the strong reliance on intuition in VCs’ decision making.
5. The high success ratios indicated that nearly all the cases advisors handle result in a positive investment decision.

References


### Appendix 1. Summary of the key characteristics of the entrepreneur and perceived benefits for involving advisor.

<table>
<thead>
<tr>
<th>Bernstein</th>
<th>Entrepreneur 1</th>
<th>Entrepreneur 2</th>
<th>Entrepreneur 3</th>
</tr>
</thead>
<tbody>
<tr>
<td>Previous entrepreneurial experience</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Year of foundation of the venture</td>
<td>2007</td>
<td>1997</td>
<td>2001</td>
</tr>
<tr>
<td>The turnover of the company</td>
<td>€40m</td>
<td>€10m</td>
<td>€3m</td>
</tr>
<tr>
<td>Number of employees</td>
<td>100</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>Industry sector</td>
<td>ITC</td>
<td>Manufacturing of machines and equipment</td>
<td>Component manufacturing</td>
</tr>
<tr>
<td>Year of the VC investment</td>
<td>2007</td>
<td>2006</td>
<td>2004</td>
</tr>
<tr>
<td>Size of the investment</td>
<td>€20m</td>
<td>€1.5m</td>
<td>€0.5m</td>
</tr>
<tr>
<td>Co-invested</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Invested in stages</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Form of investment</td>
<td>Common equity, debt</td>
<td>Common equity</td>
<td>Common equity</td>
</tr>
<tr>
<td>Found the advisor</td>
<td>Belonged to entrepreneur’s business network</td>
<td>Search for alternatives</td>
<td>Through a friend</td>
</tr>
<tr>
<td>Time period: identifying a need for funding – investment decision</td>
<td>14 months</td>
<td>3 years</td>
<td>12 months</td>
</tr>
<tr>
<td>Advisors helped in: Writing the business plan</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Polishing the business model/revenue plan</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Locating additional advisors (lawyers, accountants, referrals)</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Investment meetings</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Coaching for the ‘pitch’</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Selecting VCs</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Selecting corporate venture capitalists (CVCs), foreign VCs and business angels (BAs)</td>
<td>CVCs</td>
<td>Foreign VCs, CVCs</td>
<td>No</td>
</tr>
<tr>
<td>Negotiations</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Decreasing the time it took to get funding</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Improving deal terms in the contract</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Improving the valuation</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Enhancing understanding on VCs’ operational procedures</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Keeping informed with what was going on</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Entrepreneur had disagreements with advisor</td>
<td>No</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Benefits outweighed the costs</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Entrepreneur would use an advisor again</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Appendix 2. Case study protocol.

<table>
<thead>
<tr>
<th>Phase</th>
<th>Activity</th>
<th>Specifics in this research project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Getting started</td>
<td>Definition of research question(s), analysis of existing theoretical</td>
<td>By reviewing existing literature, the two main research questions were formed and constructs of agency theory</td>
</tr>
<tr>
<td></td>
<td>constructs</td>
<td>and resource-based view analysed. Also, previous research on advisors in venture capital investing was</td>
</tr>
<tr>
<td></td>
<td></td>
<td>analysed, of which two existing articles (Murray and Wright 1996) and (Hustedde and Pulver 1992) were</td>
</tr>
<tr>
<td></td>
<td></td>
<td>examined in great detail.</td>
</tr>
<tr>
<td>Selecting cases</td>
<td>Specified population and theoretical (not random) sampling</td>
<td>(a) A pilot interview with a legal advisor that did not contaminate the small sample of advisory firms.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) All specialised advisory firms in Finland that were members of FVCA were contacted and five out of six</td>
</tr>
<tr>
<td></td>
<td></td>
<td>were interviewed.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(c) Three entrepreneurs that had utilised advisory services and four VCs were interviewed to gain a more</td>
</tr>
<tr>
<td></td>
<td></td>
<td>objective view of the benefits advisors provide.</td>
</tr>
<tr>
<td>Crafting instruments</td>
<td>Multiple data collection methods and qualitative and quantitative data</td>
<td>Data collection methods:</td>
</tr>
<tr>
<td>and protocols</td>
<td>combined</td>
<td>(a) All respondents were interviewed once using semi-structured interview forms, except for two advisory</td>
</tr>
<tr>
<td></td>
<td></td>
<td>firms that were contacted for follow-up interviews.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>(b) Advisory firms’ websites, ppt-documents and other material was reviewed.</td>
</tr>
<tr>
<td>Entering the field</td>
<td>Overlapping data collection and analysis (including field notes); use</td>
<td>Detailed collection of data using ‘24 hour rule’ transcribing of the material. Analysis of ‘additional data’</td>
</tr>
<tr>
<td></td>
<td>of flexible and opportunistic data collection methods</td>
<td>from other sources (e.g. Beta’s fee structure was discovered using other source). Verifications and</td>
</tr>
<tr>
<td></td>
<td></td>
<td>additions were asked from interviewees when needed, after the interviews, using both email and phone.</td>
</tr>
<tr>
<td>Analysing the data</td>
<td>Within case analysis, cross-case pattern search using divergent</td>
<td>A summary of the results of within and cross-case analysis is presented in Table 1.</td>
</tr>
<tr>
<td>Shaping propositions</td>
<td>techniques</td>
<td>Even though the study has a descriptive and exploratory nature, why causalities are not hypothesised, and</td>
</tr>
<tr>
<td></td>
<td>Logic across cases, search for ‘why’ behind relationships</td>
<td>structured as research propositions, the size of the deal and the entrepreneurs’ relevant</td>
</tr>
</tbody>
</table>
Appendix 2. (Continued).

<table>
<thead>
<tr>
<th>Phase</th>
<th>Activity</th>
<th>Specifics in this research project</th>
</tr>
</thead>
<tbody>
<tr>
<td>Enfolding literature</td>
<td>Comparison with similar and conflicting literature</td>
<td>Data were compared with previous VC–entrepreneur research and some contradictions were found. The role of advisors should be studied in more detail. Based on the empirical findings, it seems that advisors are an extremely important source of support and help for entrepreneurs.</td>
</tr>
<tr>
<td>Research closure</td>
<td>Theoretical saturation if possible</td>
<td>Table 1 presents a summary of the advisory firms and their operating procedures. According to the table, advisory firms’ operating procedures are rather similar and, therefore, it can be argued that theoretical saturation has been reached.</td>
</tr>
</tbody>
</table>
ARTICLE 5

TESTING CERTIFICATION EFFECT OF VENTURE CAPITALISTS

Earlier version of the article was presented in RENT 2006 Conference.

Oskari Lehtonen
Certification Effect of Venture Capitalists

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1) The author wishes to express his gratitude for Dr. Marjo-Riitta Parzefall, Licentiate Tom Lahti and participants of 50th RENT conference in Brussels for their comments and encouragement on earlier versions of the paper. In addition, the author would like to express his gratitude for Toni Laine for his invaluable help regarding the data that this article is based on. All errors and inconsistencies are mine.

2) Oskari Lehtonen is writing his PhD part-time at the Swedish School of Economics and Business Administration. In addition, he has just raised several millions of VC funding for his new venture which is operates in Finland.
Certification Effect of Venture Capitalists

ABSTRACT

Purpose – Venture Capitalists’ (VCs’) certification effect and implications of the phenomenon have been largely overlooked in extant literature. When VCs’ invest into a venture, the VC certifies to other stakeholders that the venture is worth taking seriously and is better than other ventures that operate in the same line of business. Earlier attempts to examine certification effect in VC context have been made especially in terms of IPO pricing and valuation of sequential financing rounds of VC backed companies. However, the need of certification may be even higher for very early stage firms that are characterized by high information asymmetry.

Methodology/Approach - In this study I will examine VCs’ certification effect in terms of media attention towards VCs’ portfolio firms utilizing quantitative event methodology. I hypothesize that VCs’ investment certifies portfolio firms and their media attention increases after the investment event. In addition, I will utilize qualitative content analysis to understand better the nature of the media attention of VCs’ portfolio firms.

Findings – The results are based on longitudinal data of 29-48 firms in Finland. They show that VCs’ portfolio firms’ media attention increases significantly after the investment event providing positive consequences for both VCs and portfolio firms.

Originality/value: In the paper I promote a new approach by combining online news databases and event methodology. The proposed approach could offer a very promising method to study various cause-effect relationships. In this particular case it provided us additional information of VCs’ certification effect towards portfolio firms.

Keywords:
Signalling, certification effect, venture capital, entrepreneurship

INTRODUCTION

Entrepreneurs and their financiers, venture capitalists (VCs), form a close dyad and their relationship has been researched extensively (see e.g. Denis, (2004) or Barry, (1994) for literature review of entrepreneurial finance). Extant literature has identified and conceptualised three ways how a VC can provide value added for entrepreneurs. The most tangible element of VC involvement is funding. In addition to funding, a VC may provide its
portfolio company nonfinancial benefits such as recruitment help, access to networks and consulting help. The third benefit from VCs is certification effect (also called signalling). In short it means that when a VC invests into a venture, the VC signals to other stakeholders that the venture is worth taking seriously and is better than other ventures that operate in the same line of business (Steier & Greenwood, 1995). Both funding and nonfinancial benefits have attracted considerable research attention (see e.g. Sahlman, 1990; Sapienza, 1992; Muzyka, Birley, & Leleux, 1996). However, compared to the above mentioned, certification effect is rarely studied in VC context and studies that have been conducted are of pre-IPO firms. In this study, I will analyse certification effect among all kinds of Finnish firms that have received VC funding. This study makes two main contributions. First, it develops a new way to assess VCs’ certification effect. Second, by drawing on the collected data it provides support for the importance of certification effect which to date has received limited empirical attention and has perhaps been underestimated.

The remaining of the paper is organized as follows: in the second section I will present relevant literature, develop hypothesis and discuss operationalization of the variables. In the third section I will discuss the data, analysis and results and in the final section will present the limitations of the study and the concluding remarks.

LITERATURE REVIEW AND HYPOTHESIS DEVELOPMENT

Signalling theory in its essence is about signals that are perceivable and can be used to assess the true nature of a certain hidden aspect or quality. For example, the type of a car that a person drives could be used as a signal of the person’s wealth. Similarly, an applicant’s education and previous job experience could be used as a signal of how the person might perform in a new position (Spence, 1973). When information asymmetry is high, signals may

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1 See an exception in Seppä & Maula’s working paper (2001). The authors show using Venture Economics’ database that top VCs’ investments are associated with higher short-term value creation than other VCs. The authors suggest that top VCs are able to certify their portfolio firms which explains higher value creation.
provide additional or the only method to assess the nature of a particular quality of interest. In
new venture context it may be especially difficult to evaluate and assess the quality of the
firms. For example, questions such as whether a technology that a firm is developing will
succeed or fail, how effective a new drug will be for treating certain symptoms are very
difficult to evaluate by outsiders such as potential employees, distributors or co-operation
partners. Consequently, they may base their evaluations on signals such as whether investors
believe in the firm and invest in the firm or not. Such a signal may, therefore, provide an
effective method to decrease the information asymmetry and increase the firm’s credibility.
Below I will use the term certification effect to describe signals that VCs create by investing
in firms.

EARLIER CERTIFICATION EFFECT STUDIES IN VC CONTEXT

Earlier attempts to examine the certification effect in VC context have been made
especially in terms of IPO pricing and valuation of sequential financing rounds of VC backed
companies (Megginson & Weiss, 1991; Barry, Muscarella, Peavy & Vetsuypens, 1990)². These studies show that VCs can provide considerable benefits for their portfolio firms in
terms of certifying the price of initial public offerings (IPOs). VC backing has been shown to
lead to lower post-IPO price performance and consequently to lower total costs of going
public and higher net proceeds for going public firm. However, certifying effect of VCs can
be considered to have a broader effect than just for the correct valuation and exit prices of the
portfolio firms. This is especially important since IPOs are only one exit method. According

² Another context where signalling theory and certification has been utilized in VC-entrepreneur
context/relationship has been, for example, to test how entrepreneurs’ initial investments signal quality and
long-term performance of the venture. However, Busenitz, Fiet, and Moesel (2005) failed to find such an
association. Prasad, Bruton, and Vozikis (2000), in turn, showed in their conceptual paper that business angels
could utilize the proportion of entrepreneurs’ wealth invested in a venture as a signal and decision criteria.
Davila, Foster and Gupta (2003) studied and found evidence that VC investment signals employee growth. Davila et al.’s work has another similarity with the current study since the authors have also utilized event methodology in their study.
to Cumming and MacIntosh (2003), who used U.S. and Canadian data between 1992-1995, only less than 30 percent of VC exits were conducted using IPO while alternative methods were acquisition, secondary sale, buyback and write-off. Moreover, after the financial market crash in early 2000 the number of VC backed IPOs in U.S. has dropped dramatically from over 200 IPOs in 2000 to less than 30 in 2001, 2002 and 2003 annually (Sinha, Gonzalez, & Aase, 2003). In addition, the certifying effect can be considered to have most importance when information asymmetry is especially high i.e. in seed, start-up and growth phase ventures, not when firms are preparing for their IPOs (Seppä & Maula, 2001). These early stage firms are often short of employees, additional finance, partners, customers, suppliers and other critical resources (Lichtenstein & Brush, 2001). Therefore, an independent party with high reputational capital that invests in the venture may signal outsiders that this firm is better than its peers and may, therefore, help resource acquisition.

Megginson and Weiss (1991) and Booth and Smith (1986) suggest that in order for the certification to be credible three criteria need to be met in a certification event. First, the certifying agent needs to have his/her reputational capital at stake. In other words an unsuccessful investment should provide considerable disadvantages for the VC. In practice, unsuccessful investments have at least three negative consequences for VCs: First, VCs’ compensation is based on investing in successful ventures. VCs and limited partners share a part of the portfolio’s return (typically a VC’s share of “carry” is 20%) (Sahlman, 1990). Second, making unsuccessful investments may make it more difficult to raise additional VC funds from limited partners (Barnes & Menzies, 2005). Third, it may be more difficult to attract the best possible investment candidates if a VC is not able to show a consistent track record of backing successful investments. The second criteria by Megginson and Weiss, is that any one time wealth transfer for a certifying agent cannot exceed the reputational capital at stake. VC business does not operate by going concern principle, instead VC funds have a
limited lifespan (often 10 years). A VC that would provide false certification signals might seriously harm its attempts to raise additional funds and it is unlikely that any onetime benefits of false certification would exceed this. The third criteria of a credible certification event, is that it should be costly to receive certification from the agent. In other words, entrepreneurs that get VC investors should “pay” for the VCs’ involvement. In VC literature it is a broadly acknowledged fact that VC funding is a very expensive funding mechanism for entrepreneurs (see e.g. Sahlman, 1990) and, therefore, also this third criteria applies. In sum, from theoretical point of view, it seems that it is well founded to extend certification effect to cover also other phases of the VC-entrepreneur relationship than only exit by IPO (see e.g. Tyebjee & Bruno (1984) and Pratch (2005) for of various phases of VC-entrepreneur relationship).

HYPOTHESIS

One reason for the lack of research on certification effect apart from studies that concentrate on the IPO phase of a VC cycle could be that it is very complex to study how various stakeholders (e.g. potential customers and employees, partnering candidates etc.) perceive VCs’ investment event and the possible certifying effect. Simply, the problem is how to credibly measure the VCs’ certification effect. One possibility could be to arrange an experiment where the relevant test persons would compare both ventures that have received VC funding and peer companies that have not received VC funding. That kind of research project could be very difficult to manage and would demand extensive resources. In addition, organizing a credible testing environment might be challenging3. Earlier studies have been on VC backed firms’ post-IPO price performance. The certification phenomenon has been proved by comparing two samples of firms: VC-backed and control firms and the assumption

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3 See e.g. Gustafsson’s (2004) doctoral dissertation where she utilizes experiments in her study of entrepreneurs’ decision-making.
of existence of certification effect has been made due to different price behaviour of VC-backed and non VC-backed firms (see e.g. Megginson & Weiss, 1991). The operationalization of certification effect and the hypothesis that a venture’s price performance and a VC’s involvement should have an association have been made by the researchers. However, VCs’ certification should have other positive effects for the VC-backed ventures’ as well. Following this thought I have developed a new measure to test VCs’ certification effect among all kinds of portfolio firms. I have operationalised VCs’ certification effect as media attention received by the portfolio firms (increased media attention will, in turn, have numerous positive consequences on firms’ operation e.g. recruit new employees, attract new customers or form new partnerships). Previous research on VCs’ value added has been either criticized for using only case studies or cross-sectional data to draw conclusions on VCs’ value added or when longitudinal empirical data has been used no statistical significant association between VCs’ value added and the performance of portfolio firms was discovered (Busenitz, Fiet & Moesel, 2004). In my study of VCs’ certification effect I am able to test certification phenomenon by using longitudinal data which is a significant improvement to existing research.

In more detail, I calculate the amount of articles that were published in two leading Finnish financial newspapers before and after the first venture capital investment. I expect that VCs’ investment will certify portfolio firms and they will become more interesting in the eyes of media. In consistence with certification literature I expect, therefore, that VC investment should increase VCs’ portfolio firms’ media attention and I hypothesize:

*Hypothesis 1: The media attention received by a portfolio firm increases after an investment made by a venture capital firm.*

The second hypothesis relates to the discussion of Top-VC vs. other VCs and the magnitude of certification effect. It has been shown that VC firms differ, at least in terms of experience,
expertise and knowledge (i.e. quality). For example, Rosenstein, Bruno, Bygrave, and Taylor (1993) showed that CEOs with a Top-20 VC firm as the lead investor rated the value of the advice from their venture capital board members significantly higher than the advice from other outside board members. CEOs with non Top-20 VCs as the lead investor, in turn, found no significant difference between the value of the advice from VCs and other outside board members. Lange, Bygrave, Nishimoto, Roedel and Stock (2001) showed that companies backed by high quality VC firms and taken public by high quality underwriters had higher market capitalisations and produced higher returns for their VCs than other companies. In addition, it has been shown that entrepreneurs are willing to relinquish their ownership with considerable discount for Top-VCs compared to other VCs (Hsu, 2003). Aligned with this I expect that the higher the reputational capital at stake (i.e. the more qualified the VC) the higher the certification effect. Therefore, I hypothesize:

_Hypothesis 2: Top-VC backed portfolio firms’ media attention increases faster after an investment event than the media attention of other VC backed portfolio firms._

Next I will discuss data and methodology as well as present the results of my analysis.

**DATA, METHODOLOGY AND ANALYSIS**

The data was collected in two stages. First I collected data of Finnish VC funded firms that are members of Finnish Venture Capital Association (FVCA). This approach produced 439 suitable portfolio firms. After that CEOs or other member’s of the firms’ management teams were contacted by email and a few weeks later a reminder email was sent out. In the email, the recipients were explained the purpose of the study and ensured of confidentiality. Altogether 104 replies were received (24%) but only 29-48 firms (7% and 11%, respectively) were usable in hypothesis testing. E.g. firms that operated abroad, had a very complex company history or had been founded less than two years ago (I used time periods of 180,
360 and 720 days before and after the investment as my analysis periods) were excluded from the analysis. Recipients were asked to provide short open-ended answers to the following three questions:

- The date(s) when VC(s) have invested for the first time into the venture (due to the nature of VC investing various investment rounds are often conducted and a new VC can participate in later rounds)\(^4\).
- Name of a peer company that the recipient considered to be as similar as possible to the recipient’s company at the time of the investment event.
- Information whether VCs had encouraged entrepreneurs to practice more active PR towards media.

**EVENT METHODOLOGY**

In order to test hypothesis I utilized the principles of event methodology. Event methodology was originally developed to measure how an unanticipated incident affects share price (McWilliams, Siegel, & Teoh, 1999). This “incident” could be anything between death of a key executive (Worrell, Davidson, Chandy, & Garrison, 1986) and impact of strikes on shareholder wealth (Becker & Olson, 1986). The main difference of my approach against vast event study literature is that previously the consequences of an event were measured as changes in share price. I will measure the change in terms of media attention prior to and after the VC’s investment event. Many critical aspects of traditional event studies are relevant to my approach (McWilliams et al., 1999). First, the length of the analysis period in event studies that are conducted using share price data has been most commonly between 1 and 3 days. In my study I used significantly longer periods of 180, 360 and 720 days. The difference is explained due to the reason that stock markets are much more effective and new

\(^4\) When the recipient reported only a month when the VC investment had taken place I used the 15\(^{st}\) of that month as the event day in my analysis.
information should influence share prices almost immediately. In the research setting of VCs’ portfolio firms, the information flow is not that efficient and only a limited amount of articles are published daily. Therefore, significantly longer time periods are obligatory. In event methodology literature, however, it has been acknowledged that the longer the time period is the more likely it is that it contains also reactions that are not a result of the phenomenon under research. I have tried to eliminate the problem of extended time period by comparing peer companies and case companies and by using a fairly large sample (see e.g. Table II below). Another method to eliminate the problem related to extended analysis could be a content analysis of the articles. It could provide more information regarding the reasons why a particular article has been published and unwanted articles could be eliminated in the process. In addition, as discussed in the final phase of the article, I consider that all publicity is good publicity for portfolio firms and, therefore, inclusion of all articles are also well founded.

Second, it is imperative to identify the event date reliably. The date should represent the actual date when the information became available for the market. My main method to identify the event date has been that I have asked it from the entrepreneurs. If the information has been on the market before (i.e. VC investment has been mentioned in newspapers Kauppalehti or Taloussanomat before the date that the entrepreneur reports), the earlier date has been used as event date (see also footnote 4 regarding to identification of an event date).

**ANALYSIS**

My analysis proceeded as follows: after the event date was determined I checked articles that were published during three time periods prior to and after the event date (180, 360 and 720 days) from online databases of two leading Finnish financial newspapers Kauppalehti (KL) and Taloussanomat (TS). There were altogether 344 articles of the case
companies. Descriptive statistics are presented in Table I. Among the sample of 48 firms the growth of articles before the investment event and after the investment event for Kauppalehti and Taloussanomat is 137% and 123% respectively for 720 days period.

In order to test whether the growth of media attention is statistically significant I conducted a paired sample t-test for three time periods. The results were significant in all time periods and are reported in Table II. This implies that VCs certify their portfolio firms and that VC investments increase firms’ media attention.

However, another justified explanation for the increased media attention is that VC backed firms are high growth firms and that their growth of media attention is due to their natural growth not VC backing. In other words, the firms develop rapidly and their media attention grows accordingly. In order to test whether this was the case, I conducted a similar analysis for peer companies that I did for the VC backed firms. Peer companies were identified by asking entrepreneurs of case companies to name the most suitable comparison for their firm. Descriptive statistics of case peer companies are presented in Table I as well (lower rows). Among the sample of 29 firms (only 29 of the survey results were usable) the growth of articles before the investment event and after the investment event for Kauppalehti and Taloussanomat is 2% and 19% respectively for 720 days period. 29 peer companies resulted 161 articles. In addition, none of the t-tests for time periods of 180, 360 and 720 days for peer companies was statistically significant suggesting that peer companies’ media attention grows fairly steadily and there is no statistical difference between the two time periods. This suggests that for the peer companies the above argument of increased media attention due to natural growth of the firms is more appropriate and that VC backed firms’ media attention increases significantly faster.
In sum, both tests above support the first hypothesis that VCs certify their portfolio firms. However, I wanted to also ensure that VC-backed ventures’ increased media attention was not a consequence of VCs’ more active PR policy towards media that they might have installed after they had invested in a firm. This presumption is not implausible since it is recognized that VCs can have profound effects on their portfolio firms (Macmillan, Kulow & Khoiylian, 1989). In the questionnaire I specifically asked this information from the entrepreneurs but I found very little evidence on this. Only three firms out of 31 confirmed that VCs had in fact encouraged them to be more active in their media relations, suggesting that VCs’ encouragement did not explain the increased media attention.

In Figure 1 I have illustrated the development of media attention of both VC backed and peer companies. The Figure illustrates the results that media attention of the peer firms increases modestly (probably due to the growth of the firms). For VC backed firms the growth is significantly higher after the investment event.

In order to test the second hypothesis, VC firms were divided into two groups: “Top-VCs” and “Others” based on industry experts’ opinions. A similar technique has been used in previous studies of top management teams in VC context (see e.g. Lange et al., 2001). I conducted six expert interviews among industry professionals to identify top VCs. Five of them were partners of advisory firms that helped entrepreneurs to acquire VC funding and one was a managing partner of a law firm that has both VCs and entrepreneurs as clients. Based on these interviews I classified the VCs into Top-VCs and others. Four VCs were
considered as Top-VCs and 30 VC firms as “Others”. In my sample, Top-VCs had been responsible for eight investments and other VC firms for 40 investments. Unfortunately the data did not enable me to conduct reliable statistical tests and, therefore, the results are only indicative. Based on my data there is not a great difference among publicity of Top-VC backed and other VC backed ventures between pre-investment and post-investment periods except that overall media attention is on average higher for Top-VC backed firms prior to and after the investment event. For Top-VCs there were 5,1 articles per firm during pre-investment period and 11,6 articles for post-investment period. For other than Top-VC firms the figures are: 1,6 articles and 3,7 articles. However, the proportional growth level is almost the same: 127% and 133% for Top-VCs and other VCs, respectively. The descriptive statistics regarding hypothesis 2 are presented in Table III.

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  Take in Table III
........................................................................................

Finally, in order to further understand the nature of media attention for VC backed firms I conducted a content analysis among all 344 articles on VC backed firms (161 articles of peer companies were excluded from the content analysis). I used a priori coding scheme (Weber, 1990) where I coded the articles based on two characteristics. First in three groups:

a) Positive articles, that covered how the firm had grown, launched a new product, won new account etc.

b) Negative articles, that covered how the firm was performing negatively etc.

c) Other or mixed articles, that had both positive and negative information about the firm or the firm was only mentioned as an example (and not as a particularly positive nor negative example)

In addition, I wanted to analyse how commonly VC firms were mentioned with their portfolio firms in these articles and, therefore, I conducted a second content analysis where I
coded the articles depending on whether the VCs were mentioned or not (not just any VC firm but the specific VC firm that had invested in the portfolio firm). In content analysis it is common that, two people independently code the material and ensure the reliability of the coding (Weber, 1990). However, considering the simplicity of the coding scheme, this was deemed unnecessary. The results of my content analysis are presented in Table IV.

Interestingly, not only the number of articles where VCs were mentioned had grown from three articles to 76 articles after the investment period. Also the articles where VCs were not mentioned had grown from 101 articles to 164 after the VC investment event. Content analysis, therefore, provides additional support for the first hypothesis that VC-backed firms attract more media attention after the investment event. In addition, it is worth noticing that only a very small number of articles were negative (14 articles). This provides additional support for the main assumption of this study that media attention is in general a very positive feature for firms.

DISCUSSION

This study promotes a new way to operationalize and test the certification effect of VCs. Current research has concentrated on examining the valuations of sequential VC financing rounds, exits and IPO price performance while VCs’ certification during other stages of VC cycle has been overlooked. However, certifying effect can be considered to have most importance when information asymmetry is especially high (Seppä & Maula, 2001) i.e. in seed, start-up and growth phase ventures, not when firms are preparing their IPOs and, therefore, the current approach can be considered appropriate and relevant.
In order to analyse certification effect in detail I have utilized various data collection methods and methodologies: 1) survey data (with specific questions such as on which date and which VC invested in the firm), 2) open ended question regarding VCs’ involvement on venture’s PR policy. In addition I have used 3) an extensive amount of data from the leading Finnish financial newspapers Kauppalehti and Taloussanomat. The data covers 344 case company articles and 161 peer company articles. I have also conducted a content analysis of the case company articles. 4) Moreover, I have checked from various sources such as trade register database and ventures’ websites for information regarding when the firms were founded and I have, hence, ensured that they fit the criteria of the study. Finally, 5) I have interviewed industry experts in order to classify VC firms into Top-VCs and others. I was able to show that VC backed firms’ media attention increases significantly after the investment event and, for example, firms’ normal growth does not explain the increased media attention. These findings support hypothesis one, that VCs’ certify their portfolio firms. The small sample size did not enable me to run statistical tests regarding the second hypothesis. However, according to descriptive statistics it seems that media attentions does not differ significantly between Top-VC backed firms and other VC backed firms except that Top-VC backing is associated with higher publicity in both pre-investment and post-investment phases. This indicative finding is contrary to expectations and may relate to the small sample.

LIMITATIONS

This study contains also limitations. Some of them are associated with the selected methodological approach and operationalization of VCs’ certification effect as media attention and some relate to data and data collection. First, the operationalization of certification (i.e. certification = media attention) can be and should be discussed in detail. It is
possible that firms can influence the amount of publicity that they receive in newspapers. Regarding this I have, for example, excluded articles in which firms announce that a new employee has started in their firm. This is a common practice in Finland. The firms probably consider that these articles provide positive signals; the firm is growing and expanding its operations. Recruitment announcements are not, however, edited material and are hence excluded them from the data. Respectively, all other material can be considered as edited material and is included in the analysis. Journalists and editors have made their choice to include or exclude any particular article. The editing process, therefore, actually supports my operationalization that certification can be measured as the amount of articles published in newspapers. I.e. VCs’ investments influence journalists’ tendency to write more often about those firms than they did before the investment.

Another issue that relates to the operationalization of certification as media attention is that I cannot fully ensure that it is the certification that causes the increased media attention. I am promoting the idea that VC’s investment certificates the ventures and they become more of interest to media. On the other hand, one could argue that due to the reason that the venture gets more resources when a VC invests into it the venture starts to attract more interest in the media. There are very few methods to ensure which phenomenon is more accurate, but for both entrepreneurs and VCs the most important is probably to identify what happens to the media attention of those ventures after the VC investment. That has been documented in this study using Finnish data.

The third aspect regarding operationalization is that the central assumption of my study is that all portfolio firms prefer that they get more media attention. This assumption may contain some shortcomings. For example, some firms may not want to actively be in the media or their primary target audience does not read financial newspapers Kauppalehti and Taloussanomat that I used in the study but, for example, some industry specific publications.
My analysis is not able to capture media exposure of these other sources. My assumption that “all publicity is good publicity” is obviously not agreed by everybody but on average it can be assumed that small and medium size firms consider increased publicity good for their business. In addition, according to the content analysis only 14 articles out of 344 were categorized as negative (see Table IV).

Fourth, it is worth noticing, that commonly in event studies industry effects that may have influenced the share price should be eliminated (McWilliams et al., 1999). For example, if one firm from the same industry than the sample firm announces high growth figures or a positive future outlook during the analysis period it may increase the share price of all the firms in the same industry and bias the results of event analysis. In my study, I have not excluded industry effect, since the purpose is to analyze media attention of portfolio firms and all publicity is considered positive for portfolio firms. I assume that VC’s investment increases the credibility of a firm and, hence, the firm is mentioned more often either as an example (e.g. due to industry effect) or as the subject of an article than before VC investment.

Data collection has also several issues that need to be discussed and limitations of them need to be kept in mind when the results of this study are assessed. First, my data collection was not able to 100% ensure that all articles of portfolio firms were included in the analysis. Even though basically article search of newspaper databases can provide an objective measure compared to, for example, a survey where informants’ replies could be influenced by performance of the venture, personal issues and other unwanted factors, there are still problems with the approach. First, if a portfolio firms’ name was not mentioned in the article but, for example, a product name was, I am not able to ensure that all such articles were included in the analysis. I reviewed all the sample firms’ websites and tried to ensure that also product names were checked but there is a risk that not all were included. A similar problem relates to mergers, acquisitions, spin-offs and other transactions. Some firms had
such a complex history that they had to be excluded from the study. For example, I was not always able to confirm when a spin-off or a merger had occurred and consequently it was impossible to decide whether that particular firm was a part of VC backed venture or not and whether those particular articles should be included in the study or not. When ever possible I used official trade register for checking company history and background in order to ensure that correct coding was conducted. If I was not able to credibly ensure that the firm was suitable for the study it was excluded from the study. Second, I did not use a pre-tested survey form nor did I use a group of questions to study one phenomenon that could have improved the reliability of the answers. The reason for my approach was that entrepreneurs are commonly very busy and submitting a longer survey form would have likely lowered the already now very low response rate. In addition, the questions that I asked were fairly easy to understand (1) when VCs have invested? 2) name of a peer company? and 3) have VCs encouraged to increase PR?) and, therefore, only a brief email survey approach was selected. Third, I was not able to test non-response bias. I had very little information about the 439 sample firms. Most commonly only the name of the firm from a VC’s website and, therefore, I was not able to test how well my respondents matched with non-respondents in terms of e.g. size, business sector or geographical location. The final limitation and concern relates to the selection of peer companies. I asked the entrepreneurs to name the peer company that they regarded as similar as possible to their firm at the time of VC funding. However, it is difficult to ensure how good a match those peer companies actually are and I do not have in detail information regarding the peer companies. VCs’ investment analysis process (also called due diligence) provides some evidence that peer companies should be fairly good comparison firms. Before VCs invest in the potential portfolio firms they often conduct very thorough analysis of the investment candidates. For example according to Fried and Hisrich (1994) 71% of venture capitalists also contact competitors before they decide whether to invest in a
venture or not. Consequently, entrepreneurs should have fairly good understanding of their biggest competitors during the investment event.

CONCLUDING REMARKS

Regardless of its limitations this study provides insights to the discussion of VCs’ certification and value added of venture capital. Previous research has provided contrary results: Some research has found support for VCs’ nonfinancial value added (e.g. Sapienza, 1992), whereas other studies suggest that VCs do not add value (e.g. Manigart, De Waele, Wright, Robbie, Desbriéres, Sapienza, & Beekman, 2002; Gomez-Mejia, Balkin, & Welbourne, 1990). These studies have used various data sources and methods and analyzed only VCs or both VCs and entrepreneurs and, hence, it may be explained that the results vary. My study contributes to the literature of value added of venture capital by showing that there exists at least one less disputable value added component for portfolio firms: increased media attention caused by VC involvement. The selected research approach of utilizing secondary data of published articles before and after the VC investment (including content analysis) could offer a very interesting, novel and objective measure to study cause and effect relationships that have been studied in VC literature before, such as 1) comparison of specialized VCs and other VCs (Manigart et al., 2002) or VCs, corporate VCs and business angels, (Van Osnabrugge, 2000; Elango, Fried, Hisrich, & Poloncheck, 1995) 2) VCs’ time allocation 3) implications of co-investing (Bygrave, 1987; Elango et al., 1995), 4) association between location between a VC and a portfolio firm and value added (Elango et al., 1995), 5) CEO dismissal (by VC). In sum, many interesting and influential studies of venture capital would be possible to replicate utilizing this “media attention” approach. In addition this method could be used to study aspects that have been previously largely overlooked in literature. For example how the source of money (i.e. type of investor and/or limited partner)
influences portfolio firms (Wright, Sapienza, & Busenitz, 2003) or how additional financial rounds by the same investor influence the certification (and value added).

The practical implications of the identified certification effect can be considered mainly positive to both entrepreneurs and VCs. First, entrepreneurs with very little credibility may utilize the credibility that VCs provide them. This could help them, for example, to attract additional funding, recruit employees, win customers or negotiate partnership agreements. Entrepreneurs commonly report on their websites who their investors are. This can be interpreted so that entrepreneurs already today utilize VCs’ certification in their business. As this study shows VCs’ certification can significantly increase portfolio firms’ media attention, therefore, perhaps even broader utilization of VCs’ certification could benefit entrepreneurs. Second, venture capital funding can be considered a very expensive funding method for entrepreneurs, but often the only realistic one (see e.g. Fried and Hisrich, 1994) in their case study article of 18 ventures none of the firms could have considered any other funding method than venture capital). Therefore, certification effect and the positive consequences for entrepreneurs could be something that VCs could utilize when they try to convince entrepreneurs to agree on the terms of the investment. Finally, according to my study only three VCs recommended entrepreneurs to increase their media contacts after the investment event. This is something that VCs could consider in broader sense. It is clear that media is willing to publish articles of VC-backed portfolio firms.
REFERENCES


### TABLE I
Descriptive Statistics

<table>
<thead>
<tr>
<th>Time Period</th>
<th>Case companies</th>
<th>Peer companies</th>
<th>Change 720 days prior to / after</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>KL / TS together</td>
<td>KL / TS together</td>
<td></td>
</tr>
<tr>
<td>720 days prior to</td>
<td>21 / 17</td>
<td>24 / 15</td>
<td>0.44 / 0.35</td>
</tr>
<tr>
<td>360 days prior to</td>
<td>22 / 17</td>
<td>11 / 9</td>
<td>0.46 / 0.35</td>
</tr>
<tr>
<td>180 days prior to</td>
<td>17 / 10</td>
<td>10 / 8</td>
<td>0.35 / 0.21</td>
</tr>
<tr>
<td>180 days after</td>
<td>50 / 31</td>
<td>6 / 10</td>
<td>1.04 / 0.65</td>
</tr>
<tr>
<td>360 days after</td>
<td>34 / 18</td>
<td>16 / 8</td>
<td>0.71 / 0.38</td>
</tr>
<tr>
<td>720 days after</td>
<td>58 / 49</td>
<td>24 / 20</td>
<td>1.21 / 1.02</td>
</tr>
<tr>
<td>Change</td>
<td>137 % / 123 %</td>
<td>2 % / 19 %</td>
<td>9 %</td>
</tr>
</tbody>
</table>

The first row reports the amount of articles in six different time periods in two Finnish financial newspapers Kauppalehti (KL) and Taloussanomat (TS). The second row reports the proportional amount of articles per portfolio firm. In the lower part of the Table the corresponding figures are reported from peer companies.

### FIGURE I
Case Companies and Peer Companies Media Attention

![Case Companies and Peer Companies Media Attention](image-url)
### TABLE II
T-test for Case Companies and Peer Companies

<table>
<thead>
<tr>
<th></th>
<th>Mean</th>
<th>Std. Deviation</th>
<th>Std. Error mean</th>
<th>Lower</th>
<th>Upper</th>
<th>t</th>
<th>df</th>
<th>sig. (2-tailed)</th>
</tr>
</thead>
<tbody>
<tr>
<td>720_prior-720_after</td>
<td>-3.55556</td>
<td>3.72209</td>
<td>0.62035</td>
<td>-4.81493</td>
<td>-2.29618</td>
<td>-5.732</td>
<td>35</td>
<td>.000</td>
</tr>
<tr>
<td>360_prior-360_after</td>
<td>-1.46667</td>
<td>2.0405</td>
<td>0.30418</td>
<td>-2.0797</td>
<td>-0.85363</td>
<td>-4.822</td>
<td>44</td>
<td>.000</td>
</tr>
<tr>
<td>180_prior-180_after</td>
<td>-1.17391</td>
<td>2.04727</td>
<td>0.30185</td>
<td>-1.78188</td>
<td>-0.56595</td>
<td>-3.889</td>
<td>45</td>
<td>.000</td>
</tr>
<tr>
<td>720_prior-720_after(peer)</td>
<td>-0.24138</td>
<td>3.34509</td>
<td>0.62117</td>
<td>-1.51379</td>
<td>1.03103</td>
<td>-0.389</td>
<td>28</td>
<td>.701</td>
</tr>
<tr>
<td>360_prior-360_after(peer)</td>
<td>-0.06897</td>
<td>1.53369</td>
<td>0.2848</td>
<td>-0.65235</td>
<td>0.51442</td>
<td>-0.242</td>
<td>28</td>
<td>.081</td>
</tr>
<tr>
<td>180_prior-180_after(peer)</td>
<td>0.06897</td>
<td>0.59348</td>
<td>0.11021</td>
<td>-0.15678</td>
<td>0.29471</td>
<td>0.626</td>
<td>28</td>
<td>.537</td>
</tr>
</tbody>
</table>

### TABLE III
Comparison of Top-VCs and Other VCs

<table>
<thead>
<tr>
<th></th>
<th>Prior to</th>
<th>After</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td>Top-VCs</td>
<td>41 (5,13)</td>
<td>93 (11,63)</td>
<td>127 %</td>
</tr>
<tr>
<td>Other VCs</td>
<td>63 (1,58)</td>
<td>147 (3,68)</td>
<td>133 %</td>
</tr>
</tbody>
</table>

Amount of articles of Top-VCs' portfolio firms and other VCs' portfolio firms are reported both prior to and after the investment event. Proportional figures are in parentheses.

### TABLE IV
Content Analysis of the Articles

<table>
<thead>
<tr>
<th></th>
<th>VC mentioned</th>
<th>VC not mentioned</th>
</tr>
</thead>
<tbody>
<tr>
<td>Positive articles</td>
<td>2 (55)</td>
<td>56 (96)</td>
</tr>
<tr>
<td></td>
<td>57</td>
<td>152</td>
</tr>
<tr>
<td>Mixed articles or firm has been mentioned as an example</td>
<td>1 (19)</td>
<td>39 (62)</td>
</tr>
<tr>
<td></td>
<td>20</td>
<td>101</td>
</tr>
<tr>
<td>Negative articles</td>
<td>0 (2)</td>
<td>6 (6)</td>
</tr>
<tr>
<td></td>
<td>2</td>
<td>12</td>
</tr>
<tr>
<td></td>
<td>3 (76)</td>
<td>101 (164)</td>
</tr>
</tbody>
</table>

The first figure in the cell reports the amount of articles prior to investment event and the second figure in parentheses the amount of articles after the investment event. The figure in the second row of a cell reports the total amount of articles.


