

THE VALUE ADDING ROLE OF V2C – SEARCHING EVIDENCE FROM THE VALUE-ADDED PROVIDED BY PRIVATE EQUITY INVESTORS

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Abstract

The objective of this study is to sketch the value adding role of the V2C actor. The research question is approached from three different angles by using a conceptual analysis. The streams of research investigated are: growth related problems and needs of entrepreneurial start-ups, value-added by venture capitalists and investment criteria of venture capitalists. The results indicate that V2C actors should concentrate on more hands-on and time-consuming forms of value adding than venture capitalists do. V2C actors should also prepare the entrepreneur – especially his or her mind – to be “investment ready”. The findings are also in line with scarce earlier research.

Keywords

Venture-to-Capital, Value-added, Value adding, Venture capital, Growth entrepreneurship

INTRODUCTION

Venture-to-capital and value adding

Towards the end of the last millennia the size of venture capital funds – and hence the minimum size of venture capital investments – increased phenomenally. This also caused a shift in venture capital financing from seed and start-up to growth and buy-out financing. Simultaneously business ideas and businesses in general have developed towards more knowledge (vs. capital) intensive, and more than money new ventures need hands-on development. Hence, two gaps – namely equity and knowledge gaps – have torn between new ventures and venture capital industry. To bridge these gaps new actors are emerging to fulfil the Venture-to-Capital or V2C field and backup e.g. business angels and incubators helping ventures to cross these gaps. (Rasila et al. 2002)

Figure 1 introduces the stakeholders of this activity and emphasises the co-operation between them. Venture capitalists, and even some V2C actors, can be labelled as private equity investors.

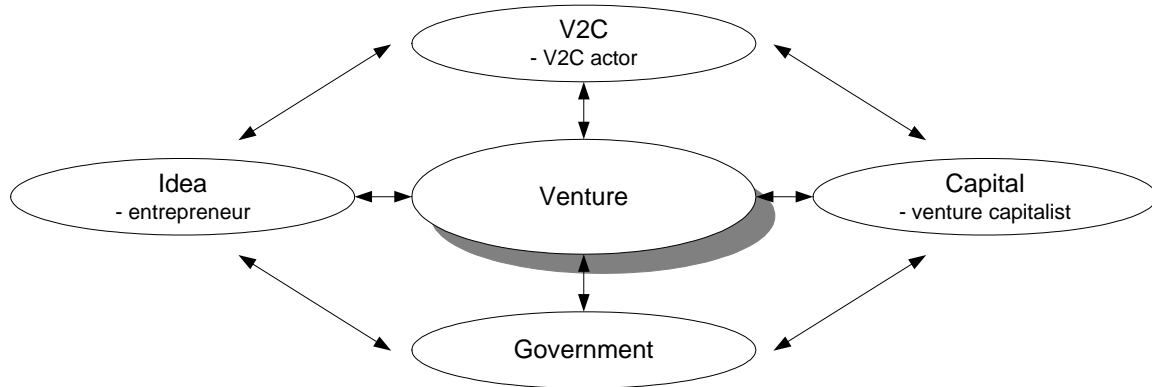


Figure 1. V2C phenomenon

According to EVCA¹ “*private equity* provides equity capital to enterprises not quoted on a stock market. Private equity can be used to develop new products and technologies, to expand working capital, to make acquisitions, or to strengthen a company’s balance sheet. It can also resolve ownership and management issues ... Venture capital is, strictly speaking, a subset of private equity and refers to equity investments made for the launch, early development, or expansion of a business.” In addition to venture capitalists, e.g. business angels, and in the matter of fact everyone making equity investments in not publicly quoted companies, are private equity investors. The difference is that venture capitalists are legal entities whereas business angels are wealthy individuals.

It is widely accepted that besides money, private equity investors provide *value-added*, which in this study refers to all non-financial benefits the portfolio companies receive from their investors (cf. Maula 2001). It has even been argued, that it is far more important whose money you get than how much you get or how much you pay for it (Timmons 1983). The different forms of value-added are discussed later in this paper.

Research question and method

This study seeks an answer to the question,

what should be the value adding role of V2C actors?

In other words, what value needs to be added into a venture to increase its possibilities to successfully raise venture capital. Herein, role is defined as someone’s “usual or customary function” (Collins English Dictionary, 2000). The study aims to delineate this role with the means of conceptual analysis. To recognise the real needs of entrepreneurial ventures, this study builds on three well-researched and documented streams of research: problems and needs of entrepreneurial start-ups, value-added by venture capitalists and investment criteria of venture capitalists. (See Figure 2.) All this is made to develop a better model for pushing ventures to capital keeping in mind that value adding deals are tailored case by case based on investee’s need for assistance, willingness to accept advise, the V2C actor’s expertise relative to the industry, and personal relationship with management (Byers 1983).

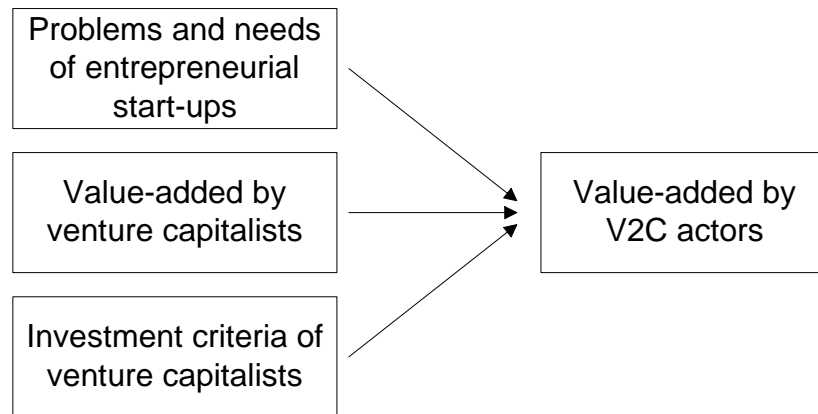


Figure 2. Research framework

Earlier research

There has not been much research made on value adding of V2C actors. However, business angels and business incubators have been under some research in this sense. Harrison and Mason (1992) found that formal venture capital investors (venture capitalists) tend to put more emphasis on control function than informal venture capital investors (business angels). This finding is further supported by their later research (Mason and Harrison 2000a) concluding that business angels “contribute their commercial skills, entrepreneurial experience, business know-how and contacts through a variety of hands-on roles to make a wide range of strategic, monitoring and supportive inputs”. Harrison and Mason (1992) also concluded that neither venture capitalists nor private investors provide helpful assistance for entrepreneurs by providing contacts with suppliers or in development of product/service techniques. The other areas of least contribution by venture capitalists included development of actual products/services, providing contacts with customers, and motivating personnel. According to Ardichvili et al. (2000) business angels help ventures to shape business concepts, assist them in finding additional sources of capital, recruit key personnel, assist in the development of strategy, and play active roles in the post-investment governance of the firms.

Business incubators should, in addition to office space, provide services like hands-on management, access to finance, legal advice, operational know-how and access to new markets (Aernoudt 2002). Seidel (2001) found that business incubators add value for CEOs in four ways: 1) value of the incubator network (who), 2) value of gaining CEO expertise within the incubator (how), 3) value of regular feedback (how well), and 4) value of incubation affiliation (why). Based on the earlier research, it looks like V2C actors provide more hands-on value-added than venture capitalists. This is in line with the development stage of venture, as in early stages ventures are supposed to require more involvement. Still the question remains, do these value adding mechanisms fulfil the needs deriving from capital and knowledge gap.

In addition, to the concrete value adding functions, having an investor often attracts a following by other outsiders. Steier and Greenwood (1995) found that social endorsement from the first investor superseded business plans in attracting additional financing from new investors. This suggests that yet having an investor, being it venture capitalist or V2C actor, means value-added. However, this form of value-added is highly related to the reputation of the given investor.

ENTREPRENEURIAL START-UP: PROBLEMS AND NEEDS

Needles to say, every entrepreneur will differ in skills and objectives. Even so, most will need some outside advisory – one person cannot master everything included in running new business. Pech and Mathew (1993) found that the nine most common causes of small business failure in order are: lack of financial planning, absence of business records, no understanding or use of business records, poor cash-flow management, poor debtor management, poor inventory management, poor costing-pricing, poor market research, and over borrowing. The research was made from the point of view of management consultants.

If asked from entrepreneurs or CEOs themselves the factors are somewhat different – in fact the causes of small business failure mentioned above fall all under internal financial management (excluding poor market research), the third biggest problem found by Terpstra and Olson (1993). They asked 121 CEOs to state the most significant problems during their firm's first year. They grouped the problems in nine categories:

1. Sales/marketing (38%)
2. Obtaining external financing (17%)
3. Internal financial management (16%)
4. General management (11%)
5. Product development (5%)
6. Human resource management (5%)
7. Production/operations management (4%)
8. Economic environment (3%)
9. Regulatory environment (1%)

The average age of the sample companies was 9 years, and the CEOs were also asked for the biggest problems in the later growth stages. The problems were somewhat similar: only the significance of human resource management (17%) had significantly increased and the significance of obtaining external financing (1%) significantly decreased.

Sexton et al. (1997) asked 150 growth-oriented entrepreneurs to address their learning needs. The needs found seem to be in line with the problems identified by Terpstra and Olson (1993). The ten most frequently mentioned needs in order were using cash flow to make decisions; financing growth; increasing value of business; compensation for self and associates; hire, train, and motivate for growth; succeeding in rapidly changing world; successful selling via helping customers to buy; sales force management; management succession; problems and pitfalls of growth.

Next, we will look at the reported value-added from venture capitalists, and, thereafter, a comparison between entrepreneurial problems and needs, and venture capital value adding is made. The mismatches between the two are reported in the final chapter.

VALUE-ADDED PROVIDED BY VENTURE CAPITALISTS

There has also been a vast supply of research made on the forms of value adding provided by venture capitalists. The below Table 1 summarises the findings of few most frequently quoted studies.

Table I. Summary of the studies made on venture capital value adding.

Author(s)	Year	Results / value adding mechanisms	Research method
Timmons	1983	<ol style="list-style-type: none"> 1) Recruiting key management 2) Industry savvy 3) Sounding board 4) Entrepreneurial climate 5) Long haul (long job, additional financing) 6) Involvement (contacts, credibility, objectivity) 7) Patient support 	In depth interviews in a venture capital backed company and of its investors
MacMillan et al.	1988	<ol style="list-style-type: none"> 1) Serving as a sound board to the entrepreneur team 2) Helping the firm obtain alternative further sources of equity financing 3) Interfacing with the investor group 4) Monitoring financial performance 5) Monitoring operating performance 6) Helping portfolio firms attract alternative sources of debt financing 	Analysis of 49 venture capitalists
Gorman and Shalman	1989	<ol style="list-style-type: none"> 1) Help with obtaining additional finance 2) Strategic planning 3) Management recruitment 4) Operational planning 5) Introductions to potential customers and suppliers 6) Resolving compensation issues 	Analysis of 62 venture capitalists
Harrison and Mason ²	1992	<ol style="list-style-type: none"> 1) Monitoring financial performance 2) Serving as a sounding board to the management team 3) Monitoring operating performance 4) Assistance on short term crisis/problem 5) Interface with other members of the investor group 6) Development of new business strategy to meet changing circumstances 	Survey data from 156 venture capital backed ventures and 36 informal investor backed ventures
Fried and Hisrich	1995	<ol style="list-style-type: none"> 1) Money 2) Operating services 3) Networks 4) Image 5) Moral support 6) General business knowledge 7) Discipline 	Interviews in 14 venture capital backed start-ups

Author(s)	Year	Results / value adding mechanisms	Research method
Sapienza et al.	1996	1) Strategic role (financial and business advice, sounding board) 2) Interpersonal role (mentor to the CEO) 3) Networking role (contacts to other firms and professionals)	The roles that venture capitalists viewed most important in France, Netherlands UK, and US

The studies named above are only discussing the different forms of value adding, not, for example, the results of the value adding activity. The venture capital value adding has also been researched regarding different regions (e.g. Sapienza et al. 1994, Sapienza et al. 1996) and factors affecting it (e.g. Sapienza et al. 1996, Barney et al. 1996). The value-added is also strongly related to the amount of face-to-face interaction between venture capitalist – CEO pairs and to the number of hours venture capitalists put in on each individual venture (e.g. Sapienza et al. 1996).

As a conclusion from these studies, there seems to be a trend towards more strategic and monitoring role from operational involvement. This evolution is caused by the so-called venture capital spiral i.e. the success of first fund often leads to a bigger second fund and, hence, also to bigger minimum investment. This development of the venture capital industry has led to a situation where venture capitalists have less and less time to spend in each investee company. (Seppä 2000, p. 142) Further, the increase in investment sizes has led to a shift of venture capital industry from seed and start-up financing to buy-out and growth financing. This development has integrated venture capital into the traditional financial market.

The final chapter will identify the mismatches between entrepreneurial problems and needs, and venture capital value adding. Before, we will shortly discuss the investment criteria of venture capitalists.

INVESTMENT CRITERIA OF VENTURE CAPITALISTS

The first widely known study on venture capitalists' investment criteria was conducted by Tyebjee and Bruno in 1984. Since that the area has been vastly examined (e.g. MacMillan et al. 1985, Rea 1989, Rah et al. 1994, Seppä 2000). To conclude, the abilities of the entrepreneur/management team is the most significant factor affecting the investment decision. Further, there has been very little evidence against the market size and potential, and uniqueness of the product being the next two most important criteria. So evidently, V2C actors should put their value adding efforts into these selection criteria used by the likely next round investors. In addition, venture capitalists expect higher rates of return, since they are also bearing higher risk, than other financiers. Besides criteria most venture capitalists have preferences like industry and venture development stage (cf. Seppä 2000, p. 182).

For an entrepreneur, the main means of communicating these factors to a venture capitalist is the business plan. The better the business plan, the higher the chance to get into a meeting with a venture capitalist and make a pitch. However, Steier and Greenwood (1995) found that

after first investor the value of business plan significantly decreases, and the following investment decisions are made based on the reputation of the first investor.

Mason and Harrison (2000b) concluded from studies made in Australia and Canada that many entrepreneurs have failed to raise equity capital because they are not “investment ready”. According to them, the term has been defined as “a state of willingness and/or preparedness to take on an external investor”. This yields yet another task for V2C actors: to prepare also the entrepreneur’s mind for venture capital investment. This can further be subdivided into characteristics, such as, having suitable ownership structure and being prepared to give out a certain amount of ownership and control. In addition, while preparing the entrepreneur for an equity investment, V2C actor can also help the entrepreneur in selecting the right investor.

The following chapter summarises and discusses the findings of the study.

VALUE-ADDED BY V2C ACTORS

When comparing the problems and needs of entrepreneurs with value-added provided by venture capitalists they seem to be rather different. In addition, it is typical that venture capitalists value their role more than portfolio companies (see e.g. Fredriksen et al. 1992). This indicates that there is a whole group of value adding activities that could be performed by V2C actors. The following Figure 3 summarises the findings of this study. As can be seen the value adding needs derived from the mismatch between entrepreneurial problems and needs, and venture capital value adding are rather involvement intensive.

From the investment criteria used by venture capitalists, it is easy to conclude that V2C actors should help ventures to develop their management team and product features. As said, the main mean to communicate these is the business plan. In business plan creation V2C actors can also help entrepreneurs to conduct product, market and competitor analysis. In addition, the V2C actor should contribute to both, how to shape the entrepreneurs mind and the ownership structure of the company, to make the company “investment ready”.

Yet further, help in managerial issues and obtaining additional finance are built in the V2C activity through the equity and knowledge gaps. A common nominator to all of the identified value adding needs for V2C actors is that they are more time consuming than the value adding mechanisms used by venture capitalists.

Problems and needs of entrepreneurial start-ups

- Sales and marketing
- External financing
- Financial management
- General management
- Product development
- HR management
- Operations management
- Compensation
- Growth management

Value-added by venture capitalists

- Sound board
- Monitoring
- Further financing
- Business strategy
- Interface with investor group
- Network
- Entrepreneurial climate
- Industry knowledge
- Management recruiting
- Operational / crisis management
- Image
- Mentor / moral support
- Compensation systems
- Discipline

Investment criteria of venture capitalists

- Team
- Product uniqueness
- Market size and potential
- Rate of return
- "Investment ready"

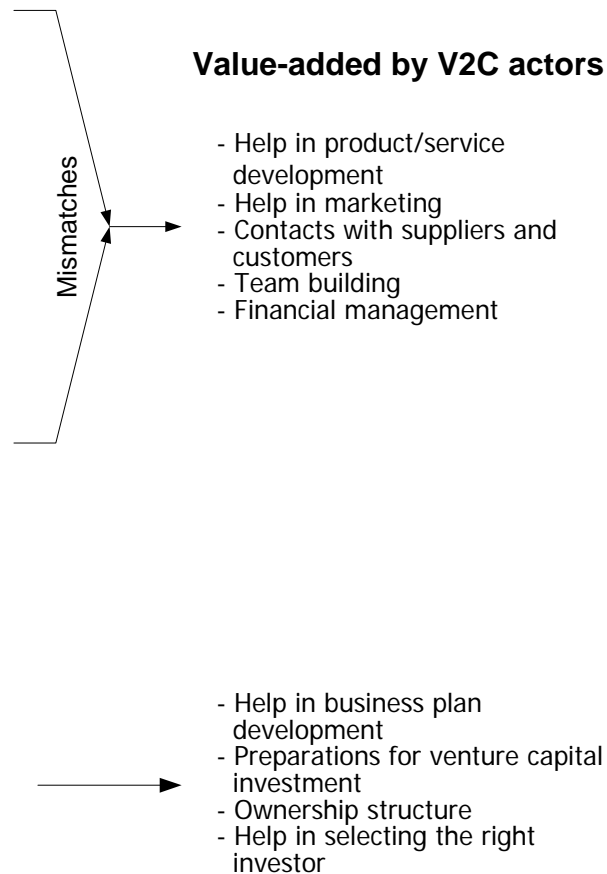


Figure 3. Value adding needed from V2C actors

CONCLUSIONS

The value adding made by V2C actor can be judged based on whether or not the target company gets venture capital investment. Hence, final conclusions cannot be made before actually testing in practise, what kind of results an operating model based on these findings can achieve. To do this, the research group is launching a project called "V2C Lab". Also, further research is needed to find out, what is the actual value-added provided by V2C actors, and what are the expectations and satisfaction level of entrepreneurs.

However, compared to earlier studies (Aernoudt 2002, Ardichvili et al. 2000, Harrison and Mason 1992, Mason and Harrison 2000a, Seidel 2001) also these findings underscore the importance of hands-on and time-consuming activities. Further, the findings also set ground for brand new roles for V2C actors. Some things that have not been mentioned earlier are the tasks related to preparing entrepreneurs "investment ready". This, however, needs to be taken care of even before any equity investor, for example business angel, is willing to invest into the company.

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¹ <http://www.evca.com>

² Harrison and Mason (1992) found that both, venture capitalists and business angels, add value in these areas.