

From Capital Investors to Knowledge Investors: The Rise of Entrepreneurial Venture-to-Capital

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Abstract

Investors deciding on behalf of society at large, which new ventures are to go forward and which not, play an almost godlike role in an economy. In the knowledge society, the role may be shifting from venture capital (VC) investors to venture-to-capital (V2C) investors: From those who invest capital to those who invest knowledge to build business from Venture to Capital. This exploratory study reports an ongoing research on the V2C phenomenon. It presents results from 14 interviews with formal and informal entrepreneurial V2C investors in Finland, a snapshot of their entrepreneurial orientation and complementarities with venture capitalists.

Keywords

venture capital, venture-to-capital, growth entrepreneurship, knowledge investing

Introduction

Filling the gaps between venture and capital

The importance of growth-oriented entrepreneurial companies to economic development and job creation is unarguable. However, the full growth potential of these ventures can rarely be realised without access to external resources. Classically, the providers of external resources, the enablers, have been labelled venture capitalists, either formal or informal venture capital investors. Brophy (1986) has argued that it is unlikely that a country or a region can be competitive without a dynamic and vibrant venture capital (VC) community. In fact, investors who decide on behalf of society at large which new ventures are to go forward, and which not, play an almost godlike role in an economy.

The supply of venture capital – and the size of an average VC fund and, hence, the amount of a minimum investment – soared towards the end of second millennium in both the US and Europe. Even after the downturn in venture capital investing after 2000, there are two key notable developments in VC activity. First, new business ideas are increasingly more knowledge intensive, driven in part by the application of ICT as an enabling technology across industrial sectors. Outside the Venture-to-Capital context Eliasson and Eliasson (1996) have discussed the idea of competence blocks and pointed to the shift in industrial organisation in a similar way.

Second, because the average size of venture capital fund has increased more rapidly than the number of venture capital investment executives, and although there is more venture capital financing available than ever before, it is not offered in small enough doses to meet the needs of many start-up and early stage companies. In Finland, the average size of seed stage investment has risen from 85 000 € in 1997 to the peak of 450 000 € in 2001 and still remaining at 250 000 € in 2003 (FVCA 2004); the formal venture capital industry has moved towards larger and later-stage investments. This trend is well-documented (see e.g. Bygrave and Timmons 1992, Sohl 1999, Murray 1999, Seppä 2000).

The two phenomena have resulted in a Knowledge Gap between prospective entrepreneurial ventures and the venture capital industry. A variety of players is now bridging the gap between entrepreneurs and venture capitalists. The actors refining prospective ventures to make them “investable”, in the eyes of venture capital industry, include incubators, advisors, business angels, corporate venturers and seed venture capitalists. These players are referred to as Venture-to-Capital or V2C actors. These partly new type of actors are filling the gap between venture and capital by bringing in the knowledge needed in growth ventures. (Seppä and Näsi 2001, Jungman, Kankaala, Rasila and Seppä 2004a, Jungman, Okkonen, Rasila and Seppä 2004b, Rasila 2004) However, very little do we know about the nature, priorities, and operating models of these new knowledge investors in the context of the operation of the early stage entrepreneurial capital market as a whole. A classification of capital vs. knowledge intensive entrepreneurial investors is presented in Figure 1 (adapted from Jungman and Seppä 2004). Horizontal axis illustrates the perceived relative portion of an investor’s knowledge vs. capital (brains vs. cash) investment.

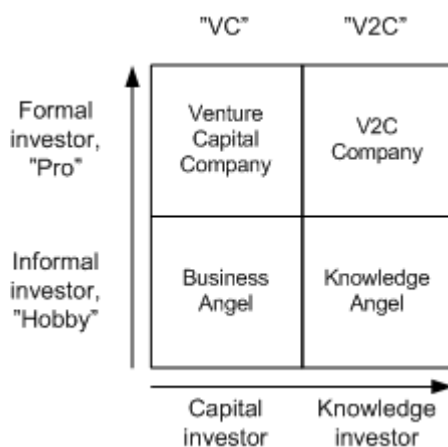


Figure 1. Knowledge-intensity of formal vs. informal investors

With the general rise of ICT enabled – and enforced – business models and concepts and, consequently, the transformation from capital intensive to knowledge intensive new venture activity, the godlike role in an economy referred to above may be shifting from those who invest (venture) capital to those who invest knowledge in ambitious entrepreneurial ventures to render them “investable” in the eyes of the venture capital industry. In the language of this study: In the knowledge society, the role of the enabling investor is shifting from venture capital to V2C investors.

Research mission and strategy

The target of this study is to shed some light on the nature of the typical entrepreneurial knowledge intensive V2C investor in Finland. This will, especially, be done in three selected dimensions of entrepreneurial orientation (EO): innovativeness, risk taking, and proactiveness (see e.g. Lumpkin and Dess 1996, Lindsay 2004). V2C activity will be seen as an entrepreneurial process. Further, as the V2C actors have emerged to act as a bridge between ventures and venture capital, it is important to know what the relationship between the V2C and the venture capital actors is. Hence, the paper will also discuss the complementarities between venture capital and V2C activity and identify opportunities for further collaboration especially in the light of sequential investing and co-investing.

The first task is to construct a guiding framework based on earlier research on V2C activity, on private equity investor's EO, and on complementarities between venture capital and V2C. At the moment, our knowledge of these phenomena is very limited. Hence, also this research is mainly exploratory by nature.

When designing the research approach for the present study, based on the authors' initial understanding of the issues at hand, a pattern of interview questions was constructed. Empirical data was gathered via semi-structured interviews conducted with seven formal and seven informal Finnish V2C investors. The ultimate aim of the study is to construct one concluding proposition for a new theoretical framework to increase our understanding of V2C activity as entrepreneurial ownership profession, and complementarities between V2C and other stakeholders – especially venture capitalists – of the growth company process.

Theoretical framework

V2C actors as entrepreneurs

There are only few studies that have made the difference between entrepreneurial and non-entrepreneurial early stage investors. A notable one is Landström's (1998) study on "Informal Investors as Entrepreneurs" (for earlier insights, see Seppä et al. 1992). Landström (1998) looks early stage investing as an entrepreneurial process, not as a financial phenomenon. He argues for example that informal investors want to be able to influence the future development of the firm, they trust their personal network as source of and assessing for investment proposals, and they put importance on trust and personal chemistry between the investor and entrepreneur. He goes as far as calling the informal investor "co-creator" and the actual entrepreneur as "co-entrepreneur".

Another way to see V2C actors as entrepreneurs is through EO theory. Herein, "an EO refers to the processes, practices and decision-making activities that lead to new entry" (Lumpkin and Dess 1996). New entry can be for example, the act of launching a new venture. The dimensions of EO have been developed over the last two decades and they include at least 1) Proactiveness, 2) Innovativeness, and 3) Risk taking (Miller 1983, Covin and Slevin 1989, Lumpkin and Dess 1996). Lumpkin and Dess (1996) also included two more dimensions, which aren't necessarily been adopted by others (Lindsay 2004): 4) Autonomy, and 5) Competitive aggressiveness. They also theoretically proved that all of these five dimensions

may vary independently in given conditions (Lumpkin and Dess 1996). Hence, they may also be studied as independent factors.

Lindsay (2004) extended the theory of EO-performance relationship to business angels. He tested 4 hypotheses with measures for EO and investment performance on 79 respondents. The results showed that business angels have an EO, and there is an EO-investment performance relationship. He adopted the definitions for proactiveness, innovativeness and risk taking from Lumpkin and Dess (1996). The same definitions are also used for this study. Herein, “risk taking involves a tendency to take bold actions, such as venturing into unknown new markets, committing a large portion of resources to firms with uncertain outcomes, and/or borrowing heavily” (Lindsay 2004). As V2C investors, by definition, are expected to invest relatively more knowledge (hands-on involvement, etc.) than capital in their target ventures, they are also expected to have the opportunity to steer their investments more closely (than venture capitalists), in other words, show proactiveness. The nature of their investment grants them relatively more post-investment risk control and therefore they are expected to accept relatively more risk at the time of initial investment. (Jungman and Seppä 2004, Van Osnabrugge 1999)

In fact, the type of risk V2C actors are willing to take resembles that of the entrepreneur. “Proactiveness is an opportunity-seeking, forward-looking perspective that involves introducing new products/services and acting in anticipation of future demand” (Lindsay 2004). In the present study, proactiveness is measured especially as involvement in investee management. In relative terms, when compared with venture capitalists, V2C actors are likely to be more proactive owners who are involved in operational management and try to initiate change rather than to react on events as members of the board. This is also presumed to show, as mentioned above, in the relative amount of invested financial capital vs. knowledge capital. Proactiveness is also expected to show in sources of deal flow. According to Lindsay (2004), EO shows in leveraging of informal networks (friends, associates, media, etc.). Innovativeness refers to a “basic willingness to depart from existing technologies or practices and venture beyond the current state of the art” (Lumpkin and Dess 1996). The core of V2C activity lies in knowledge investment. Hence, in this study, special attention is given to innovativeness in the V2C business model, the vehicle to invest knowledge.

Complementarities between VC and V2C

The research on complementarities between formal and informal venture capital markets has been very limited. Further, the formal and informal venture capital markets have very often been viewed as separate. (Harrison and Mason 2000) Instead, Harrison and Mason (ibid.) suggest that “research should move from consideration solely of the actors in the market to the analysis of the market itself and its operation”. The business angel market – and therefore the whole V2C market – should be viewed as a part of capital market. One such attempt is the growth company process illustrated in Figure 2. It does not only show the vitality of V2C and venture capital working together to build successful ventures, but also emphasises the role of government in the capital market. This kind of framework of thinking could lead to improvements in both venture capital and V2C activity and, herein, contribute to the development of new ventures.

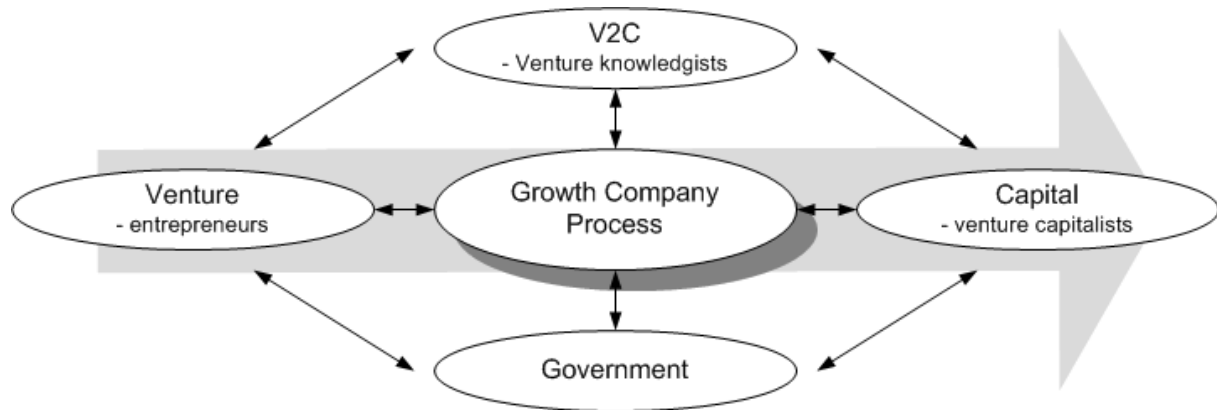


Figure 2. The Growth Company Process (Jungman et al. 2004a)

Jungman et al. (2004b) suggest that the illustrated chain thinking should show in the ownership development of the venture. In fact, we argue that V2C activity should be developed as an ownership or a “principal’s” profession, and venture capitalist’s entry should provide at least a partial exit to the V2C actor to symbolise the pass of the baton in the growth company process (cf. Benjamin and Margulis 1996). Aligning of the interests of the entrepreneur, the V2C actor and the VC actor – linking all of their primary profiting to the final exit of the venture capitalist – would also increase the supply of high quality ventures to venture capitalists.

Harrison and Mason (2000) name four types of complementarities between venture capital and business angels: sequential investing, co-investing, provision of funds, and deal referral. Of these, sequential investing is probably the most obvious and was already referred to in the previous paragraph. The existence of this kind of complementarity in the US has been well-documented. However, it is unclear whether this occurs outside the US. There is also strong evidence that business angels co-invest alongside venture capital funds in the US. Further, they often provide technology or entrepreneurial experience to assist in the due diligence and post-investment control. (Ibid.) Again, it is not clear how many Finnish venture capitalists and business angels made investments of this type. However, there are statistics that show Finnish business angels investing into venture capital funds: The peak-year of private persons’ investments in venture capital funds i.e. provision of funds in Finland was 1999 amounting total of 28 M€; before and since that (1998–2002) the amount has varied between 7 and 9 M€ (FVCA 2004). Deal referral is defined as “the informal networking of deals and deal flow between business angels and VC firms” (Harrison and Mason 2000).

In this study, we harness this framework of complementarities even to broader purpose: To study the complementarities between venture capital and V2C, and yet further, to understand the complementarities in the whole growth company process.

Data and methodology

To investigate the emerging group of entrepreneurial knowledge investors, a qualitative study of the nature and investment process of V2C investors was undertaken. This exploratory study presents results from 14 interviews with formal and informal entrepreneurial V2C investors in

Finland. In total, seven formal V2C investors (full-time based and/or incorporated partnerships) and seven informal V2C investors (part-time based and/or individual solo operations) were interviewed in Finland in April, 2004. According to the underlying theoretical framework only the activity of the interviewees related to taking capital and/or knowledge investment based ownership positions in target ventures was under investigation. Resulting from the interviews, one of the formal V2C investors was excluded from the final sample, due to non-entrepreneurial status in investment decision-making. Hence, the final sample comprised six formal V2C investors and seven informal V2C investors. Of the formal V2C investors three were classified in the category of seed venture capitalists, two in the category of advisors, and one in the category of incubators. All of the formal V2C investors were classified as business angels. However, the range of knowledge-intensity in the investment activity of the business angels interviewed was extremely varied; from almost zero capital investment to only marginal knowledge investment.

To secure comparative research data, a structured interview exercise was undertaken. In order to check the interview form, it was tested with one knowledge investor known to the researchers. The test led to light changes in the framing of the questions. The interviews were recorded and the formal sessions lasted for an average of 45–60 minutes. The interview process comprised both qualitative and quantitative questions, and an open space section. The interviews were followed by quantitative and qualitative analysis of the interview data. Preliminary results from these interviews are reported in Jungman and Seppä (2004).

Results

In general, the risk, decision making and earning model of V2C actors seem to resemble the ones of entrepreneurs. There also seems to be a willingness to work in a closer co-operation with venture capitalists. In Table 1 are presented some quotations from the interviews. Below the three selected dimensions of EO and the possible complementarities between venture capitalists and V2C actors are discussed in more detail.

Proactiveness	
	– “I invest my time, not money.”
	– “I go there to build strategic alliances and partnerships.”
	– “The existing strategic alliances and partnerships are not important; those will be made if necessary... make it investment ready for capital investors.”
	– “Very often I work as a procurer or midwife between ventures and potential owners.”
	– “If I feel that I don’t possess any relevant knowledge I will stay out of it.”
Innovativeness	
	– “...knowledge should be structured so that it’s worth money and even more than money. The most precious thing that you can give to a venture is your time. There should be a way of selling your knowledge”
	– “In my concept, I invest my knowledge and I need to get paid in one way or another... by investing I’m in the same boat with the entrepreneur.”
	– “It is healthy for companies to pay for knowledge... it seems that they are not willing to do so.”
Risk taking	
	– “... venture capital and investments made by government are not personal risk taking and are in different position than informal investors as they don’t invest their own money but have collected it from somewhere else.”
	– “Return potential is more important [than risk control], especially when talking about sweat capital investments. The more [financial] capital is involved, the more the weight of risk control perspective will increase; in other words, the already well-earned money is not willingly lost.”
	– “You have been too risk-averse if you don’t get financial losses from time to time.”
Complementarities	
	– “Syndication in a way that a business angel invests money, but doesn’t take an active role [in a company], and accepts that we get the same share of ownership without matching financial investment, and knows that we will make work to the venture.”
	– “We can acquire second-round financing to the ventures – not necessarily from our own fund, but from other investors... our task is to make it [the venture] look like a company to get it to a growth path.”
	– “Our skill is to get the capital investor in there [to the venture].”
	– “There should be an easy way for business angels to become owners in ventures and to make an exit possible at the time of the next financing round. This way we could accelerate the circulation of money; a person like this could make a new investment to somewhere else.”
	– “The entrepreneur expects to get much more knowledge or sweat capital from the venture capitalists than he/she actually gets, because a) there is no knowledge and b) there is no time.”

Table 1. Quotations from the interviews

V2C actors as entrepreneurs

“A lonely wolf is a poor predator.” (Informal V2C investor interviewed)

Many of the interviewed V2C actors expressed their willingness to work in close co-operation with the founders; they even feel that they are “in the same boat with the entrepreneur”. This is further testified by the fact that nine of the interviewees rate the team as the most important selection criteria. The remaining four rate the team as the second most important selection criteria after market expectations (3) or product features (1).

Of team skills, seed venture capitalists seem to value track record, capabilities and skills, whereas other V2C actors value softer characteristics such as enthusiasm, commitment and attitude. All investors seem to emphasise market growth rate, but in addition, capital intensive

seed venture capitalists seem to weight the competitive situation in the market to the same extent. Out of the deal characteristics for informal V2C investors, advisors and incubators, the most important appears to be their own “involvement in business development”, whereas seed venture capitalists weight syndication and their own status as lead vs. co-investors. These findings further support our thinking that knowledge intensive V2C actors are after someone to work with – and emphasise shareholder chemistry, whereas more capital intensive seed venture capitalists are more after someone to make money with.

From the results of this study, it is likely that V2C actors show high amount of *proactiveness*. They seem to value their own activity and informal networks as sources of deal flow. Only two of the interviewed V2C actors perceived that they invest more capital than knowledge. The interviewees also heavily expressed their non-financial contribution in the investee companies; going as far as refusing from the opportunity if they felt that money is only aid they can give. Many of them also highlighted their skill to acquire venture capital.

Most of the interviewees ponder upon the same question: How to get paid for investing knowledge? They are willing to look for new *innovative* operating models to tackle this problem. These findings also indicate that there is a need to better assess the complementarities between venture capitalists and V2C actors. The options they offered to investee companies included delayed payments, loans without securities, and payments based on the profits of the investee.

There seems to be a strong correlation between *Risk taking* and knowledge intensity of the investment; the higher the knowledge intensity the higher the possibility that V2C actor weights return potential over risk control in other words is willing take relatively more risk. The risk taken is in the personal level – V2C actors are typically investing their own time and money unlike most of the government schemes and venture capitalists. Also in this sense V2C actors resemble entrepreneurs.

When analysing the deal flow and investments from the past year we found that formal investors typically made one investment per 50 proposed deals, whereas, informal investors typically made one investment per 10-15 proposed deals. This indicates that formal investors put more weight on pre-investment activity than informal investors. Further, V2C actors with high relative knowledge intensity tend to look for deals where they can be involved in business development; this also indicates the relative importance of post-investment activity as risk control mechanism. Seed venture capitalists, on the other hand, seem to weight the pre-investment related characteristics of the deal.

Complementarities between VC and V2C

Some of the interviewed V2C actors had already established a strong co-operation with venture capitalists. All the four forms of complementarities were employed by the interviewees, but form was heavily affected by the amount of investible capital. Most of the interviewees had venture capitalists in their networks and also deal referral existed. As mentioned above, many of V2C actors said their strength to be in acquiring venture capital; a clear sign of sequential investing. Also co-investing existed in a very developed form – at least in the level of an idea: venture capitalists invest the money and V2C actors the knowledge.

Conclusions

“During the last couple of years we have, indeed, clearly transformed from a capital investor to a knowledge investor.” (Formal V2C investor interviewed)

Due to the nature of the present study, the investigation is not amenable to generalisations. However, we find convincing, case-based support for the V2C argument – that those who primarily invest knowledge are rising to challenge the role of those who primarily invest capital as key enablers of economy. This is not to suggest that knowledge investors are about to replace capital investors, quite the contrary. Knowledge investments without capital investments to follow would often be as useless as ever before. Instead, knowledge investors may be emerging as the factor that makes the difference for the success of capital investors. What we see here is an emergence of a new profession (that of V2C actor, knowledge investor, co-entrepreneur, professional entrepreneur, professional owner, or venture knowledgist). Although not irrefutably proven here, the above notion is in full conformity with the general perception related to knowledge society development, that value is increasingly created by chains, if not networks, of companies, rather than individual players.

This paper has been one of the first attempts to look at the complementarities between V2C actors and venture capitalists using Finland as the case environment. We found that increased collaboration and profit partnering between entrepreneurs (V), knowledge (V2C) and capital (VC) investors, and government is called for. However, before the full potential of cooperation can be realised, there are questions to be answered, two of the foremost being the issue of valuing invested knowledge and sweat capital, and providing sufficient exit routes for V2C actors. Needless to say, further research especially on these issues is needed.

The implications of this study will mostly benefit entrepreneurs in search of V2C services and financing, and policy makers in search of new ways to enhance the creation of new businesses. However, it will also benefit V2C actors and venture capitalists by increasing the understanding of each other's business dynamics as well as researchers studying the phenomena at hand.

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