

**V2C OR VENTURE-TO-CAPITAL – NEW MODEL FOR CROSSING THE
CHASM BETWEEN START-UP VENTURES AND VENTURE CAPITAL**

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Abstract

The aim of this paper is to describe the space between initialization of a company and the moment when it has reached a state when it is attractive to the formal VC financing industry. The space is referred to as Venture-to-capital, or V2C space. The paper analyzes the origins of this space and discusses a new operating model for helping the companies to overcome the challenges in this space.

This paper continues the work reported in Seppä and Rasila (2001) and describes work in progress.

INTRODUCTION

Background and Objectives of the Paper

Venture Capital has grown from mysterious game of insiders to a fairly universal industry and well established model of business. Venture Capital (VC) financing is most often considered as one of the alternatives for funding a company in need of capital for growth or start-up companies in general. The message we hear from the VC companies is that “every viable company will get funded” and that the most critical factors in decision-making are the Management Team, Product and Market.

This, however, is not the whole truth, as VC companies are shifting towards capital-intensive later-stage investments and thus leaving smallest capital needs unattended¹. Still, these investment needs are not satisfactorily catered with the “friendly money” available from the informal sources, such as friends and relatives. At the same time, number of prospective companies is flourishing due to lower inhibitive barriers and encouraging examples of fellow entrepreneurs who have put up a company and successfully launched it to the orbit.

Let us ponder upon which factors are the key contributors to this undesirable development. First of all, what has happened to venture capital industry, which was originally established for just this reason: to back up promising companies in their early stages and facilitate their success? What are the current imperfections in the financing market between the informal and formal capital market, ie. between where the friendly money ends and where the VC money starts? And finally, what can be done to overcome these issues?

These questions are answered first by defining the gap between formal and informal VC market or – conceptually - the chasm between venture and capital. Since essentially the challenge is to push venture to capital, let us call this gray area “V2C space”, where V2C stands for Venture-to-Capital. Having done this, we can start analyzing the characteristics of different phenomena within this area.

Definitions and Limitations

Before entering the discussion about the development and current state of the V2C environment, it is appropriate to define certain terms used in this debate. First of all, Venture-to-Capital or V2C refers to the area between the state when a company is looking for or in need of a VC investment and the state where it is eligible for a capital investment. Companies in the first state are referred to as Prospective, and the latter group companies are called Investable.

V2C operative is the actor, a legal entity or natural person performing V2C activities in V2C space, ie. the Venture-to-Capital operating area. The goal for V2C operative is to find companies, which can be defined as Prospective, and by V2C operations assist them in becoming Investable, ie. fit for receiving an investment for a VC company. Then, it is the task of VC investor to guide the company further until it becomes Listable, which refers to the status when the company can either be listed in public market or is an attractive target for a trade sale transaction². These statuses together with respective phases in the company life span are presented abreast in the attached table. The table also demonstrates the operating mode for each stage; the development from solo operation to VC funded operation via V2C stage, together with an illustrative time line.

<i>Company phase</i>	SEED	START-UP	GROWTH
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¹ The “minimum investment” limit of VC companies was in some cases found out to be as high as USD 5 million in the study “eForum Work Package 3.4: Report on User’s Needs”.

²Term ”Listable” is convenient but may un intentionally undermine the importance of trade sale as an exit route, and trade sale is already underrated by venture capitalists as stated by Wall and Smith (1996).

<i>Target status</i>	IDEA TO PROSPECTIVE	PROSPECTIVE TO INVESTABLE	INVESTABLE TO LISTABLE
<i>Operating mode</i> ³	SOLO	V2C	VC
<i>Months from start</i>	0...24 MO.	6...36 MO.	24...60 MO.

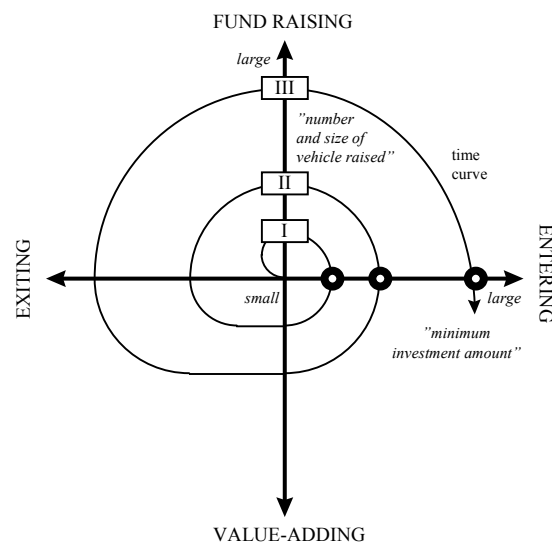
Table 1: Company Phases and terms of V2C target statuses

The table above sets the Prospective, Investable and Listable statuses in line with the traditional phases of the company; seed, start-up and growth. It should be noted, however, that Prospective, Investable and Listable are goals, ie. something, which the company should reach out for, not something “given”. Therefore, in the table they are called “target status”.

When looking at Table 1 we have to remember that not all companies fit to this model. Not only are the timescales flexible and vary from company to another, but majority of the companies overall do not wish to follow the steps outlined here. Our scenario assumes that the company wants to grow fast, expand to several market areas and at the upshot hit it big by public listing or trade sale. We should never get so narrow-minded as to think that all entrepreneurs see this as the preferred development path for their companies. Therefore, we limit our study to apply only to those companies targeting for fast growth and therefore in search of external funding.

ORIGIN OF THE V2C SPACE

After many good years the Venture Capital Funds have grown bigger as they have gained popularity among their own investors; insurance companies and pension funds being the biggest ones placing money in the funds managed by the VC⁴. This, in turn, pushes them to make bigger investments as can be seen from the venture capital spiral below.



Picture 1: The venture capital spiral ⁵

Preference of Larger Investments

The end result is that VC companies have to shift their focus from involvement-intensive seed- and start-up phase investments to more “cost effective” larger size investments. This often practically means later stage investments, such as MBO/MBI (Management Buy-In and Buy-Out, respectively) and pre-IPO, which is a low-risk placement preceding public listing ie.

³ Seppä and Rasila (2001), pp. 332-335

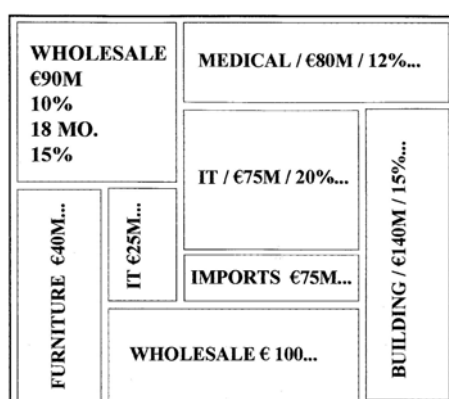
⁴ Statistics supporting these claims can be found eg. in the FVCA report “Pääomasijoittaminen Suomessa”.

⁵ Seppä (2000)

initial public offering. Characteristics of typical later-stage investment include many of the following:

- Capital raising well organized
- Large investment size
- Long and proven track record of business
- Skilled and experienced team of managers
- Low risk vs. expected income
- Short investment term

This relatively well-organized structure is illustrated in the next picture. The boxes represent investment opportunities, each one being labeled with a set of characteristics: branch, size of investment, anticipated investment period, risk and profit. These parameters can be defined in advance with rather good probability. Conceptually, the investment managers just need to monitor the market and pick the ones which suit the portfolio of their funds.

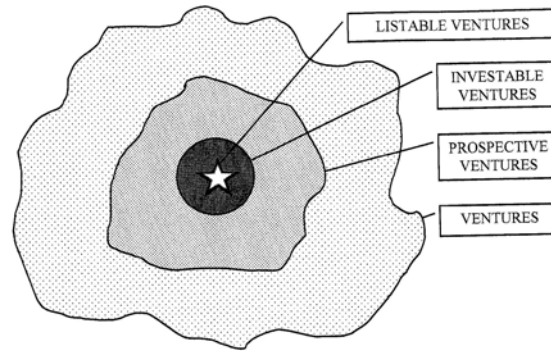


Picture 2: Simplistic Illustration of Later Stage Investment Arena

When we compare this to the characteristics depicting start-up companies in the same market, the differences are obvious and characteristics almost opposite to the previous set:

- Fairly unorganized fund-raising, often no previous VC experience
- Small investment size
- Little or no track record of business, just promising future
- Usually incomplete team of managers
- Lucrative income possibilities with high risk
- Long to extremely long investment term

To illustrate this market in contrast with the later-stage arena featured in Picture 2, a drawing with several areas within each other can be drawn. The innermost and smallest area are the successful ventures who have traveled all the way to being Listable, forming a key group within the Investable companies. Investable companies, on the other hand, are a segment inside the Prospective companies section, which in turn is but a small fraction of companies in total.



Picture 3: Simplistic Illustration of Early Stage Investment Arena

To attain even one IPO within the star in the middle section of the cloud, or let us say cake, investor has to cut a piece of the cake and eat it all. And by “eating all” we mean that all ventures have to be found and screened, some chosen to more detailed inspection and – finally – numerous positive investment decisions made. Even after this stage, all these companies will need constant care-taking and attention, and all is done for the hope that one of them will eventually be listed, or at least some of them will end up to be successful trade sales. Sadly, most of them will achieve neither.

No wonder the later-stage investment market seems more attractive to the VC investors, who are responsible to their investors for not only investing all the funds agreed to be invested, but also recovering the funds back with profit. But is this still “venture capital” activity in its original form, or should it be referred to as “merchant capital”⁶? Risk is relatively low and anticipated timing is likely to happen, which appears to be close to investment banking.

Capital Gap and Knowledge Gap

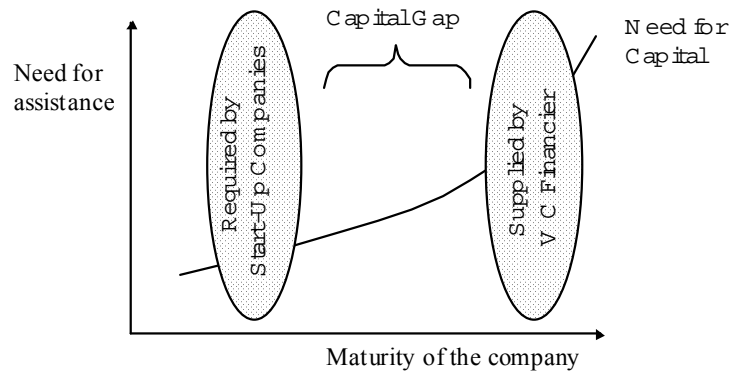
For the aforesaid reasons, there is a major obstacle especially small ventures are facing in raising capital even if the three factors mentioned in opening chapter are conformed satisfactorily: the Capital Gap⁷. It was first found and documented in 1930’s, referred to as McMillan Gap in a government study in the UK in 1931⁸. The capital gap is typically the wider – and the V2C market the bigger – the smaller, younger and more innovative the underlying prospective ventures are. In the latter part of the past century, the VC industry was looked at as the solution to the capital gap problem. Consequently, since the 1950s and the 1960s, governments in America and Europe took active measures to increase the *quantity* of VC in their underlying economies.

Effectively, the size of the V2C market is the delta between what can *already* be funded by the formal capital market and what can *still* be funded by the informal capital market. Thus, the phenomenon relates to the distance between a Prospective venture and an Investable venture. The following picture illustrates the Capital Gap area.

⁶ An interesting indication of the diversification of private capital market is that European Venture Capital Association has changed its name to European Private Equity and Venture Capital Association. In this paper, development of private equity market vs. venture capital market is not discussed due to limitations of space. Instead, the focus of this discussion is on differences the target; early stage vs. later stage.

⁷ Discussion about the subject can be found in “Venture Capital at the Crossroads” by Bygrave and Timmons (1992).

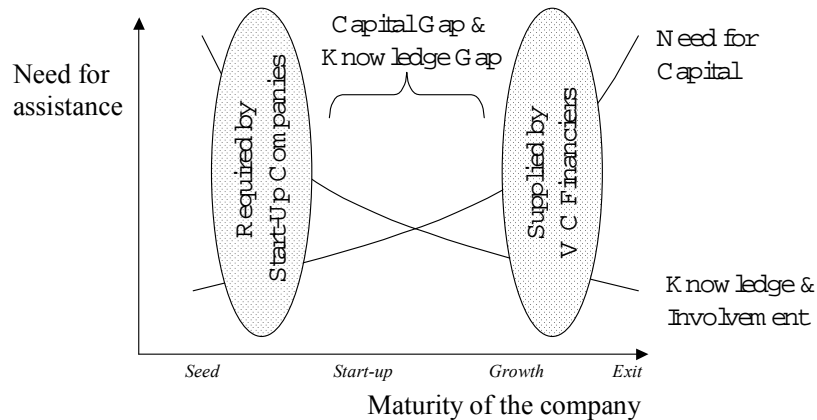
⁸ Dominguez (1974).



Picture 4: The Capital Gap

Today, presence of the capital gap is imminent and leads to trouble for those seeking small scale investment, or sometimes even up at the range €5 million as was found out in a recent EU study⁹. The same figure rose up in the *Financing New Ventures – Gaps and Gateways* summit organized by Santa Clara University in Silicon Valley in 1999, where it was stated that in our times, entrepreneurs seeking for less than €5 million in early-stage funding may be faced with the capital gap problem. This is dramatic increase to the average investment of USD865.000 by National Venture Capital Association member companies in 1987¹⁰.

What is more, it has been noted¹¹ that the promising companies are in justified need for good advisors as well – service of which was originally embedded to the VC model but which many VC companies are unable to provide nowadays due to lack of time and lack of expertise in the small business environment. This results is a dual gap as shown in the following picture.



Picture 5: The Capital Gap vs. Knowledge Gap

V2C SPACE AT THE MOMENT

Effect of venture capital spiral, capital gap and knowledge gap together are the godfathers of venture-to-capital space, causing the market to function non-optimally. And whenever there are imperfections or gaps in the free and open market, it means that there are unattended clients. And this in practise means a market for a new operative to fulfill the needs of those

⁹ eForum Work Package 3.4: Report on User's Needs.

¹⁰ Maier and Walker (1987).

¹¹ eForum project, which is part of eContent program made jointly by 8 parties in 7 EU countries, found out in its study that, not surprisingly, the need for advisors is crucial on top of financing. Same can be read from the EVCA report "The Economic Impact of Venture Capital in Europe".

clients. The question is: Do we need a new breed of players to fill the "gray area" pictured above between the investors and investees?

Hypothesis is that the answer is yes, and the real question is the operating model of this new operative. But first, let us look at the current actors operating in this space. At the moment, there are several different kinds of parties in the V2C space. For the sake of clarity they are divided them in three groups: business angels, incubators and advisors. In addition to *who* are working in this field we should contemplate *how* and *why* do they do it.

Business Angels

Business angels are, by definition, wealthy individuals putting some of their hard-earned capital, business-experience, and contact-networks back to the entrepreneurial process. They are profit-driven, market-educated players vested with an extensive value-adding potential. However, they are, by definition, also hobbyists. This is neither their profession nor full time job. Even if this is their main job, post-retirement, it does not necessarily fill the hours of their days.

Importantly, they are not dependent on any market forces to maintain a long-term in what they are doing; they do not need to serve any particular stakeholder group such as outside investors, or even the entrepreneurs. They do not seek organized growth of their business as do the players of the formal venture capital industry. In other words, bestowing them the honor they deserve as potential for experienced and motivated long-term developers of the company, we have to point out that they lack certain dynamism.

Incubators

The same holds for many incubators, but from a different angle. Most incubators are based on a formal process and professional activity. After all, this is someone's main job – not a mere hobby. However, whereas business angels personally participate as owners in underlying ventures, incubator staff seldom have such personal incentive. Many incubators are public sector based or semi-public players under the public eye with little or no space for making mistakes. In other words, their activity lacks different aspects of dynamism when compared with business angels.

Advisors

Advisors may be either individuals or consulting offices, private or public. It is their job to assist companies for monetary compensation. Compared with business angels and incubators, advisors are the most focused on their own short term gains and profitability. By definition, they are also involved for the shortest time with a given venture. On the negative side, a standard image of an adviser relates to quick-and-dirty, get-the-money-and-run type operation. Advisors are often faced with accusations according to which they do not care what happens in the client firms once they finished, and usability of the data or work they have delivered is responsibility of the entrepreneurial team of the venture.

On the more positive tone, advisors are highly skilled and motivated professionals who have seen many cases and can derive advise from experience. These skills work well in a problem-solving situation or in carrying out a given project, such as finalizing the business plan, setting up an office abroad or assisting in fund-raising effort. Also, advisors certainly work under market pressure, under pressure of profitability. This is not a hobby for them, but the mission of the company is out of bounds for them. Generally, there is no long-term relationship outside the normal client-customer relation.

Flaws of Status Quo

Among these three groups of operatives, there is substantial variation between the business models and scopes of operation. Also, during past few years, new models and hybrids of earlier ones have appeared to the market; advisors who accept – or require? - shares as partial payment for their services; incubators who invest in company and make a profit sharing incentive plan for the pay-back period, and business angels who organize a fund for individuals or a secondary market place for unlisted, high-risk shares.

Hence, even though free competition should be considered the best practise in a developing new market, it can be concluded that from the venture point of view the problem is that there are too many different actors with different kinds of incentives and business models, varying even inside their respective groups.

Additionally, the whole area is highly unorganized: Where do you go to find a business angel, and vice versa? How do you know that a specific advisor is the one who knows the complications of your situation and market best? So, we need to “re-invent the wheel” by bringing both the venture and capital back to the start-up companies.

NEW MODUS OPERANDI

Principally, the task for the V2C Operative is to guide the ”Prospective” company into being an ”Investable”, after which it is up to the company and its VC to go further to being ”Listable”. The activities include working with the administrative issues of the company as well as hands-on involvement in operative issues as needed. After all, the entrepreneur is in most cases doing this the first time and is not an expert in all the aspects of raising a company.

The operative should have intrinsic, long-term interest towards developing the target company. It should provide the company with capital but also with best available expert resources, as both of these resources are necessary in development of the company. With these resources, both capital gap and knowledge gap can be crossed.

Basic Structure of a V2C Operative

V2C operative, as it is seen at the moment, should be organized the same way as the classic venture capital company is. A management company will be set, preferably with individuals as full-time managing partners. Funds of monetary resources as well as funds of specialists (“brains fund”, see below) are organized for the disposal of the operative. Monetary funds may be managed by the V2C operative directly, or it may choose to team up with VC’s who already have the funds at their disposal. Teaming up too closely with just one or a few VC’s should be avoided, though, as this would put a brand on the V2C operative, limiting its degrees of liberty and thus potentially harming the interests of the venture.

The V2C actor will also team up with a substantial number of managers, executives, advisors and researchers, organizing them as a “brains fund”. These specialists of various fields enter the ventures as board members or advisors with small or no fee. In return for the time and services they contribute to the company, they receive a small minority in the company, which they presumably sell at the time of the VC investment to come. This way the company will get dedicated owner-advisors, who have genuine long-term interest in developing the company, and potentially many researchers and specialists get taste of entrepreneurship without having to leave their secure full-time jobs.

Entry of the V2C Operative

When a prospective company is recognized, the partners - ie. managers working full-time at the V2C operative - makes the screening and preliminary due diligence as in any VC company. If the company is found fit for V2C investment, suitable set of available specialists

is searched from the “brain fund”, taking into account that the work load is balanced equally among the specialists and no-one is acting in more than, say, three companies in different stages at any given moment.

Specialists and entrepreneurs are introduced and possibilities discussed, followed by business due diligence made by the specialists in question. If everything matches and other investment criteria are met, positive investment decision may be made and the possibly once more iterated group of specialists assigned to the company.

Reflecting to the earlier discussion about current actors in V2C space and earlier research done on VC business model¹², it may be deduced that the new operating model should introduce ownership as an initiative. Hence, at this time V2C operative will get a stake in the company making it a minority shareholder. This may happen either as a company or as individual advisors, or combination of both. Shares may be bought at face value or higher, depending on the fund mechanism implemented by the V2C operative. As a guideline, the stake might be in the region of 5-25% at this point.

Crossing the Knowledge Gap

As the specialists are introduced to the company at a very early stage and they are committed to working with the company for a relatively long period of time, one of the elements of knowledge gap is already taken care of. Moreover, in contrast with a perhaps financing and growth-oriented board member offered by a VC company, the specialists in question are selected in order to have knowledge in specific areas in which the venture needs assistance; setting up an R&D team, financial administration, international marketing and so on.

Specialist have to maintain their interest towards helping the company to overcome the advisor dilemma mentioned earlier. This genuine long-term interest is ensured with the modest ownership in the company, transfer of which should be possible if specialist wants to or has to be changed during the V2C holding period.

Crossing the Capital Gap

When thinking from the VC point of view, ventures in V2C space are attractive because of their great potential. They should be raised up the level of being big and successful enough to justify an investment. After all, this “pool of companies” is a major source for target companies for VC’s and if it is not nurtured then the VC deal flow will suffer. Still, the risk connected to these early-stage companies is high, and this is prohibitive when combined with the long investment period and small investment size.

This obstacle could be evaded by working through a V2C office, which would be sort of an agent for the VC company. Knowing that there are committed people who have genuine, long-term interest spurred by minority ownership in the company, the likelihood of investing is likely to rise. If VC can trust the teams of V2C and venture itself in managing the operative aspects of the company, the management costs can be dramatically reduced. These issues have to comply with the rules of the funds managed by the VC, of course, but whenever seed financing is allowed by the fund and normal capital placement practices are used, then there should be no legal hindrances.

On the other hand, if V2C operative is managing its own fund, placements can be done from there either alone or syndicated with other actors. To follow the classic VC model, as suggested earlier, this fund should preferably be an external legal entity with limited life span, managed with carte blanche by the V2C operative. The fund does not have to be overly large, as only seed and start-up investments would be made, and even so the V2C operative could

¹² Venture capital was found out to be ownership oriented business, not investment oriented in Seppä (2000).

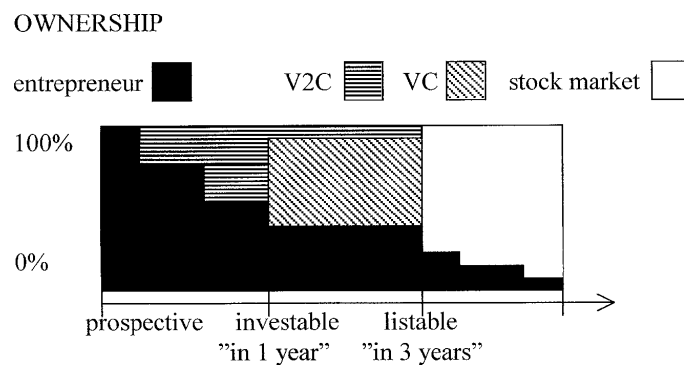
syndicate the larger end investments to save its own capital and share risk. Also, the investment period would be reasonable due to the exit strategy discussed later, which – depending on the form of fund and whether the funds would be recycled or not – might reduce the overall requirement for capital.

We can also argue that when not having to spend on advisors, the venture will save a lot in company development costs. This may be true, but the V2C are likely to suggest actions introducing new costs for the sake of fast growth, so that a source for funds should be secured to enable fluent development of the company.

In this context we have to remember two issues, though. First of all, V2C does not compete with VC companies, as it does not invest to companies which get VC funding anyway. Vice versa it serves the VC community by creating solid investee companies for them to invest in. Secondly, the V2C operative must not be too close to any VC company, as this would repel the other VC’s and thus be unfair to the investee company, who should be in neutral position when seeking for VC financing.

Exit of the V2C Operative

As V2C funding is close relative to seed financing, the investment period is infeasibly long if exit happens when the company is listed or sold entirely. Hence, at least partial exit should happen at the entry of a VC company. This concept is gaining more support also among the VC companies, as this drawback from which traditional seed financing is suffering has been recognized.



Picture 6: Distribution of Ownership in V2C Model

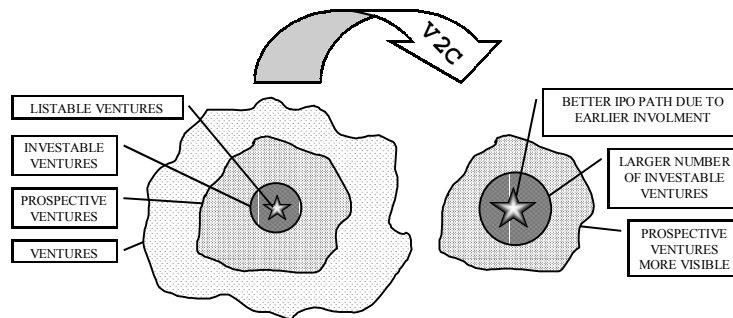
Depending on various parameters, including the actual business model of the V2C operative, the ownership may develop more or less like in the example given in the above picture. Scales are not accurate but the message is clear; V2C operative enters the company at an early stage, holding majority of its minority stake until a VC chooses to enter the company. At this point, V2C sells most of its ownership with reasonable profit, possibly leaving a trifling minority to wait for the IPO or trade sale. If individual specialists have been direct owners of the company, it is likely that the VC will want to “clean them out” from owners at this point. This is not an obstacle, however, for them to continue in these companies as paid advisors or board members.

DISCUSSION

The V2C model serves all parties well; entrepreneurs, experts, venture capitalists, government and public stock market. What is more, it targets many of the crucial imperfections in the market, which either have not been addressed by other models or are demonstrations of new potential which can be exploited by the new model. Some of these specific benefits are discussed in following.

Matching Ventures and Venture Capital

As we saw earlier in Picture 2, start-up companies are laborious to screen and cumbersome to manage for venture capitalists, making early-stage financing unattractive. This obstacle can be dramatically reduced by pre-screening the companies, effect of which is illustrated in Picture 7. It should also be noted that one of the key factors in attracting investment is a good team of managers and experts. Thus, a good team of seasoned experts from V2C organization with ownership interest will convince potential investors further.

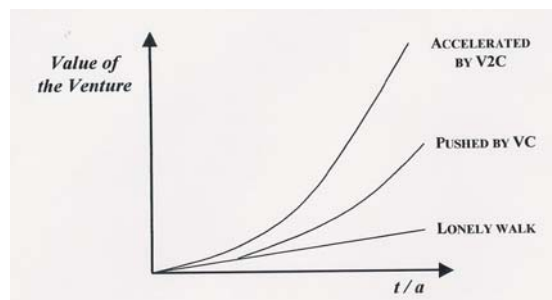


Picture 7: Effect of V2C Activities on VC

Growth of Valuation of the Company

As is the case with VC investment, valuation of the target company may be expected to rise more rapidly than without investment. Only that with V2C the accelerated growth can be started much earlier than by waiting until the company has reached the status of an investable company, which in most cases will take years from its foundation.

Another factor contributing to this outcome are the experts, as they are needed even more than money. Injecting the start-up with cash will not always result in success, but even small funds may lead to success when put to action by suitable and devoted people¹³.



Picture 8: Growth of company valuation using different growth paths

Seed financing

Widely considered to be an activity for public sector or “friendly money” coming from relatives and friends, seed financing offers the biggest uncertainties and longest investment times in the VC market. The key differences between V2C and seed financing are perhaps in depth of involvement and length of investment horizon. Seed financier may not be able to commit as much of his or her time as a team of devoted part-time experts can, taking into account the amount invested is one of the smallest in the portfolio of the VC company. And to overcome the problem of too long investment period we only need to define that the V2C company exits at the entry of a VC investor.

¹³ As taught already by Buddha: “With the humblest start and trifling capital, a shrewd and able will rise to wealth”. Williams et al.

Role and Benefits of Experts

There is tremendous potential for entrepreneurs in non-entrepreneurs. Traditionally, there have been experts like business angels and business mentors available to entrepreneurs to certain extent. This is fine, but it can be argued that more can be done. One resource which can be comfortably utilized by the V2C model are the researchers and professors of universities; they are definitely experts in their fields¹⁴, but unwilling to leave their posts to try and make a career as an entrepreneur. Nevertheless, when any expert could be part-owners and feel the heat – in good sense – of entrepreneurship without having to leave his day-to-day job, it might be presumed that good results would emerge. This would also benefit universities by bringing more job satisfaction and interaction with state-of-the-art companies.

SUMMARY

It appears evident that the V2C market is imperfect as it is today. A new mode of operating should be developed to allow “V2C operatives” to enter the market. The new operating model should use experts outside the current business angel and advisor pool, with ownership as an incentive to generate genuine long-term interest for those working in development of the company. Availability of capital itself should pose no problem, as it is more crucial to target it in small enough doses cost-effectively to enable numerous investments in early –stage ventures.

Final V2C business model or models remains to be developed in further research or in practical applications. The ultimate goal may be unattainable like the philosopher’s stone or perpetual motion. One may never find the one perfect way to assist newborn companies, but improving their operating environment is already a worthwhile and rewarding goal.

¹⁴ (sic)

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