

The V2C Phenomenon: Pushing Ventures to Capital

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SUMMARY

Venture capital has emerged from a mysterious game of mysterious players to a fairly universal industry and form of business. Venture capital (VC) financing is a standard consideration among companies in need of start-up or growth-funding, or private equity financing in general. The message of VC companies, on the other hand, is comforting: “Every viable company will get funded.” The critical factors in decision-making are “management, product, and market,” they say. This, however, is not the whole truth.

In reality, there is another key hurdle on the way to get financed – one referred to as the “minimum investment amount.” Companies falling short on this criteria will have trouble receiving VC financing from the top league players. Companies that are not out there to *consume enough investment money* are face the “capital gap.” Thanks to the venture capital spiral, successful VC players manage ever bigger investment funds and are hence faced with a constant pressure to make ever bigger single investments.

This study is about understanding the bridging of ventures and capital in today’s world – the players and strategies related to pushing entrepreneurs across the capital gap. At the present time, entrepreneurs enjoy historic worldwide appreciation and recognition as the “geese” who lay the golden eggs for societies at large by turning market opportunities and their personal drive into new exports and jobs. This study reports an ongoing investigation exploring *who* are playing with the geese, *why*, and *how*.

INTRODUCTION

The study focuses on economic actors that in many ways resemble venture capital companies. It utilises the framework of venture capitalist strategy logic created by Seppä (2000), as the primary theoretical tool, and continues the work initially reported by Seppä and Näsi (2001). To make a distinction about the focus of this

study, in relation to previous literature, we begin by categorising (investee) ventures in three categories as follows.

In this study, a venture is referred to as:

- (i) *listable* when it qualifies for public listing on a stock exchange or as a trade sale target by a corporate acquirer,
- (ii) *investable* when it is not yet listable but qualifies for investment by the formal (professional) venture capital industry, and
- (iii) *prospective* when it is not yet investable but qualifies for an organised growth effort either by an entrepreneurial or a corporate actor.

To continue making a distinction: Whereas venture capital firms concentrate in pushing investable ventures listable, this paper studies those who concentrate in pushing prospective ventures investable in the eyes of the venture capital industry. To conceptually differentiate the latter group from venture capital (VC) players, the group of actors focused herein is referred to as *venture-to-capital (V2C) players*.

Besides the V2C players themselves – their person, mission, and strategy – the study examines the demand for their services at both ends of the capital gap. Also, the study is interested in views of prospective ventures on the status of *capital* supply and - vice versa - the views of VC firms on the status of *venture* supply.

While this is predominantly a conceptual study aimed to refine an early proposition for a new framework – deriving from the emerging fields of entrepreneurship, venture capital, and corporate strategy research – an empirical effort to understand the needs at both ends of the capital gap, in the form of field surveys conducted in eight EU countries in 2001, is reflected upon. The survey in question was conducted in Finland, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the UK, during spring 2001.

CAPITAL GAP

The capital gap problem was discovered already 70 years ago, documented in a government study in the UK in 1931 (Dominguez 1974). In the language of this study, capital gap – the gap between venture and capital relates to the “distance” between a prospective venture and an investable venture. In effect, 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*. The capital gap is typically the wider – and the V2C market the bigger – the smaller, the younger, and the 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 have taken active measures to increase the *quantity* of VC in their underlying economies (Seppä 2000).

And quantity there is, in today's world of VC, but also an ever-wider capital gap. Due to the transformation of the classic concept of the VC process into VC spiral, venture capitalists increasingly suffer from "physical inability" to make small investments.¹ The capital gap dilemma was addressed in Silicon Valley by the Santa Clara University 1999 summit: *Financing New Ventures – Gaps and Gateways*. It was concluded that entrepreneurs seeking for less than \$5 million in early-stage funding are likely to be faced with the capital gap problem. Some 15 years ago, the average investment by a National Venture Capital Association member company was \$865,000 (Maier and Walker 1987).

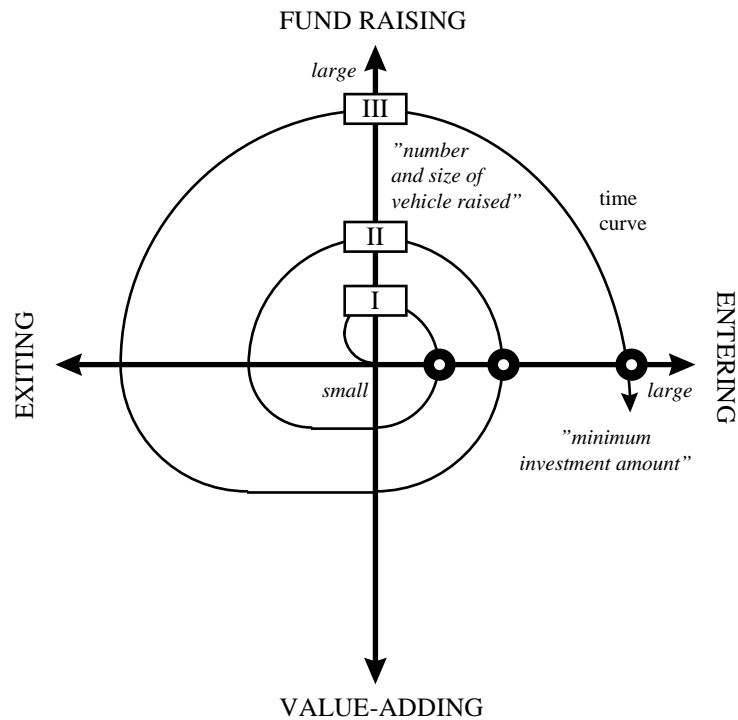


Figure 1: The Venture Capital Spiral

The above depiction (figure 1) of the VC spiral illustrates what success has to do with the capital gap problem in the VC industry. Successful investment activity with an earlier fund results in investor demand for an ever bigger fund which subsequently increases the minimum investment amount. (Seppä 2000.)

What adds irony to the capital gap problem today, is that while an unforeseen amount of capital is seeking for ventures to finance, also an unforeseen number of ventures is seeking for capital backing. Thanks to the wheel of history, the victoriously spreading entrepreneurial ideals, and the knowledge (rather than capital) intense opportunities of the e-economy, the market is again ripe for such classic

1 For a seminal exposition of the management process of a venture capital firm, see Tyebjee and Bruno (1981).

small investments that created many of the VC industry's greatest legends.² The paradox is that now that there is no shortage of capital, there seems to be a shortage of small-enough doses of it.

In their landmark book, *Venture capital at the crossroads*, Bygrave and Timmons (1992) ask with concern: "Where is the *venture* in venture capital?"³ Seppä (2000) rephrases the question and asks: "Where is the *capitalist* in venture capital?" The present study continues the quest for the capitalist in what is referred to as the V2C setting (launched originally by Seppä and Näsi 2001). On a grander scale, the study follows the path opened by Tyebjee and Bruno (1981, 1984). For an early Finnish contribution see Miettinen and Relander (1988).

Throughout the 20 years of organised research activity on the VC phenomenon, the least attention has been placed on the identity, motivation, and structure of the ones who make it happen. This research joins the likes of Amit, Glosten, and Muller (1990), Amit, Brander, and Zott (1998), and Seppä (2000) by addressing and challenging the core strategic issues of the venture capital industry. Zacharakis and Meyer (1998) put the motto of this line of study in words: "Any improvement in [venture capitalists'] understanding [of their own decision process] (which ultimately leads to improved decision-making) can have a huge economic impact for both the venture capitalist community and their funded ventures."

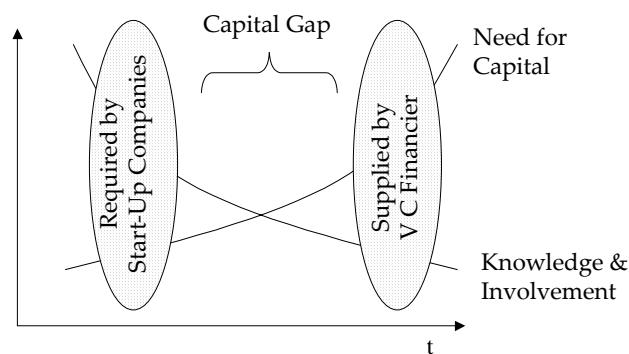


Figure 2: The Capital Gap

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- 2 In 1957, American Research & Development Corporation (ARD) invested \$70,000 in a new venture started by four MIT students, launching Digital Equipment Corporation, valued, by 1971, at \$355 million. In 1975, Arthur Rock invested \$1.5 million in a start-up that launched Apple Computer, Inc.; an investment that was valued at \$100 million at the company's initial public offering (IPO) in 1978. (Bygrave and Timmons 1992.)
- 3 As noted by Elango, Fried, Hisrich, and Polonchek (1995), the issue has become raised of how to define venture capital. Whereas Bygrave and Timmons (1992) find the differences between early-stage and late-stage investing so great that investors focusing on the latter should not be considered venture capitalists. This study points attention to how we should address the players operating "before" the formal venture capital community.

To further illustrate the gap between venture and capital, figure 2 depicts the relative need of a typical knowledge intense venture for monetary input and knowledge input as a function of time. A typical such start-up venture, depicted on the left, requires – on a relative scale – considerably more of the latter. However, the VC firms, depicted on the right in figure 2, would prefer to offer considerably more of the former. The above illustration opens a new window to the essential of the capital gap of our time. This has not to do with financial capital but with knowledge capital – something of kin to human capital – something related to investment of entrepreneurial wisdom and commitment, rather than purely financial means.

Effectively this leads us to ponder upon the roots of VC activity, the so-called classic (hands-on) venture capitalism, and the reasons for the transformation of the VC industry. Besides VC spiral related items, a number of unrelated issues help understand why “classic venture capitalists” seem to have vanished from the game field:

- VC industry has expanded rapidly and been forced to recruit people never apprenticed to venture capital, but to other forms of the art (of business)
- Appropriate education and training is scantily available at universities and comparable institutions
- Cost and profit pressures push VC managers to spend less time per portfolio company
- The VC profession has institutionalised and comprises a large number and variety of responsibilities, other than investee specific value-adding work

Evidently, there is a need for improvement in the VC industry value chain. According to the observations that have launched this research, there is a call for new players between venture and capital: Someone to push ventures to capital. Consequently, the function of these players, and their specific business models require attention. In this research, this market is referred to as *the V2C space*, and the research focus is *the V2C industry*.

The mission of this study is to contribute to understanding of the V2C phenomenon for each key stakeholder group. Besides the *owners* and *managers* of the V2C entities, if not one and same person, also their *financiers* and *target entrepreneurs*, as well as the *buyers* of their portfolio interests, and *government policy makers*, make decisions that shape the V2C business environment. Empirically, this study investigates the demand for V2C services at both ends of the capital gap. First, before addressing the mismatch between the two, venture supply will be addressed.

VENTURE SUPPLY

From the capital provider’s point of view, *venture supply* can be divided into three main sources as follows:

1. Entrepreneurial start-ups
2. Management buy-outs and buy-ins

3. Corporate venturing

Entrepreneurial Start-Ups

Entrepreneurial start-ups deal with giving birth to new *legal* persons, a reproduction process that could be referred to as the lifeline of the market economy. To an extent, the well-being and survival of also legal persons depends upon reproduction. But as is the case with *natural persons*, reproduction is no end in itself. Without love, care, discipline, and moral building, the odds of well-being and survival of a child are not increased. At young age, the role of committed parents is central to natural persons. Institutionalised children are, as sad as it is, less likely to become contributing citizens. Unfortunately, the analogy seems to hold for legal persons as well.

Parents, it could be postulated, are the *owners* of their children until adults. But sadly, as we know, this ownership in itself is no guarantee of responsibility and commitment – which is also pointing to the need for institutionalised parenthood. The same applies to new venturing. If the "best element" lacks incentive to become entrepreneurs, in a society, and rather choose a career in a large institution, institutionalised new venturing is readily justified, in analogy. This is not suggesting that institutionalisation is ever *the optimum*, however.

Management Buy-Out and Buy-In

MBOs and MBIs relate to entrepreneurial teams' acquisitions of existing and established businesses. These are typically professional-management-driven transactions of going concerns and hence less of a challenge to evaluate, finance, and monitor than entrepreneurial start-ups to a potential capital providers.

Corporate Venturing

Corporate venturing brings about new business by building on internal entrepreneurship, sometimes referred to as intrapreneurship. In environments and societies that lack entrepreneurial incentive, large corporations are natural platforms for new venture activity. Conversely, in environments boasting with entrepreneurial incentive, corporations have tougher time keeping new venture activity indoors. Compared with America, Europe relies much more on corporate venturing. As a form of "institutionalised parenthood," corporations have a significantly better track record as a platform for new venture activity than state or government related entities – although there are exceptions also to this rule. Nevertheless, the difference between the two is likely to be a function of incentives and responsibility.

It is evident that the capital gap problem relates to entrepreneurial start-ups and the parenting of prospective ventures. By definition, buyouts and buyins are more likely to be readily investable in the eyes of VC firms. Corporate ventures have internal

capital provision. Summa summarum, regarding venture supply, this paper is focus on entrepreneurial start-ups.⁴

The Venture Survey

During spring 2001, ventures labelled as "digital content companies" were surveyed in eight EU member countries. The definition used for a digital content company was broad. Companies having "activities of creation or distribution in the domain of digital content based on education, news and information, leisure and entertainment, or e-business" did qualify for the survey. They could be anything from a start-up to a going concern, as long as they judged themselves to be, in the language of this paper, either a prospective or an investable venture.

By June 15, altogether 61 such firms from Finland, Greece, Italy, Luxembourg, the Netherlands, Portugal, Spain, and the UK had responded to the survey. Hence, what will follow are some early observations on a fairly small, but nonetheless intriguing sample. Namely, most of the responses are derived from young, entrepreneurial companies somehow associated with science parks or technology centres. Of the respondent ventures as many as 40% were founded during the past 18 months. Consequently, 56% of them reported to have five or less employees, and 47% EUR 200.000 or less in annual sales.

In terms of business model, 41% felt comfortable reporting B2B as their dominant business model, 22% reported B2C, 25% a combination of the two, and only 12% other model. A striking 45% reported to have identified over ten competitors, 31% 5-10, and 24% less than five competitors. Regardless of an evidently competitive environment, 38% of the respondents estimated to outperform their competition in pace of development. Only 13% estimated being outperformed by the competition. The respondents represented early stage also regarding capital raising. As many as 39% have no outside funding and another 37% have received first stage funding; while only 24% are at later rounds. Most interestingly, as many as every fifth respondent reports to decline altogether from raising outside capital.

Reviewing the respondent comments regarding capital provision the following type comments seemed to emerge as a trend:

- "Real risk capital does not exist, capital providers always ensure their own investment."
- "Entrepreneurs invest *everything* in a venture, capital providers only invest *capital*."
- "Entrepreneurs put it all in *one venture*; to capital providers it is just a dime in a dozen."

4 As pointed out by Sexton (1986), entrepreneurial firms – defined as growth-oriented firms – play an important role in the economic development of an area. Not all firms play such role. Interestingly, Jarillo (1989) emphasises the ability and willingness to use external resources as the essence of entrepreneurship.

When judging for their nature as digital content companies, vis-a-vis technology-based ones, the respondents the following type comments seemed to emerge as a trend:

- “Capital providers prefer to finance technology, rather than e-business concepts.”
- “The dot.com bomb has cast a shadow over new economy based businesses.”
- “It is truly difficult to assess earning logic herein, and pick winners from a crowd.”

When asked to list their biggest concerns when creating their company, only 23% of the respondents pointed merely at a shortage of capital, whereas 31% picked only knowledge related concerns, such as administrative and managerial competence, and access to specific relationship networks and skilled workforce. The remaining 46% pointed at a mix of capital and knowledge related concerns. Of the respondent firms, 52% reported the source of their start-up capital as entrepreneurs, associates, family, and friends, 11% reported friendly money plus public agencies and/or business angels, 27% friendly money plus venture capitalists and/or banks, and 11% reported fully corporate sources.

All in all, the respondents agreed that access to specific relationship networks helps finding capital providers. Only 10% disagreed. They based their judgment on the following rationale:

- “Networks help getting information on financiers and on how to develop business idea.”
- “Networks are the way to find expertise, exchange ideas, and get the right contacts.”
- “Network membership creates synergy effects and adds credibility.”

A common thread within answers regarding networking was, however, insecurity. Apparently (young) digital content companies feel uncertain about their networking ability: Which networks to choose and how to join them. Of the respondents 33% indicated they had received help in building their business plan, 27% indicated they had not received any help, and 40% that they had not needed any help therein. Of those who had received help in business planning, 30% reported help from would-be financiers, 45% from a public agency, incubator program, grant, or award, and 25% from a consultant or a private agency.

Although a majority or 57% of the respondents rated their national state of mind as favorable towards entrepreneurship, an alarming 43% rated it unfavorable. When asked whether or not the venture capital sector was well developed in their underlying economies, only 33% of the respondents gave a positive evaluation. A staggering two thirds gave it a negative evaluation.

CAPITAL SUPPLY

From the point of view of an entrepreneurial venture, *capital supply* can be divided into three main sources as follows:

1. Equity
2. Debt
3. Grants

Each source is important to any venture. However, depending upon the development stage, innovativeness, and technology content of a given venture, there are differences in their relative weight. Debt is primarily available only to more established companies that have collateral. Grants, on the other hand, are primarily available only to the most technology-intense firms, and only in economies where governments have – besides the resources – such a technology policy.

By content, both debt and grants are financing in its most basic form – money. With regard to young companies and to firms of high technology content, money is enough, in today's world, only if a venture has lined up exceptional managerial talent and networks or if they exist to only serve one major client. To most ventures, particularly so to firms seeking rapid growth into world markets as independent entities, *equity* contains the keys to success. This is where the true incentive – the rationale behind all private enterprising – is baked-in. In fact, whereas debt and grants relate to mere financing, with a price tag, equity rather relates to ownership, which in this context can be considered analogous to *parenting*. This is why this paper is concentrated on equity supply.

Equity Supply

From the point of view of an entrepreneurial venture, the equity supply can be divided into three main sources as follows:

1. Entrepreneurs themselves, their family, and team members (friendly money)
2. Business angels and venture capitalists (private equity players)
3. Stock market investors (public equity players)

In the ideal environment, the entrepreneur has all incentive – both financial and social – to invest 100% of his/her capacity to maximally rapid and efficient build-up of the underlying venture. The importance of the financial incentive is easy to demonstrate; one just needs to refer to the option schemes of large corporations, whereby internal entrepreneurship is encouraged in market economies world-over. With regard to the social incentive, large corporations in Europe are vested with much more social incentive, than efforts to start up on one's own, when compared with America. Historically, self-made-men enjoy by far greater social appreciation in America than in the "aristocratic" cultures of Europe, where social status has been traditionally either inherited or achieved via loyal service to the crown or a major institution, such as the church.

Besides the relative advantage – a better social incentive environment – entrepreneurs also have an absolute advantage in America: More friendly-money available for start-ups. There is typically no need to go outside family and friends for the first round of financing; no need to "reveal one's soul to the public at infancy." In Europe, entrepreneurs are forced to cross the line and seek for private equity financing at a much earlier stage. And, in the earliest stages, public-sector-based players are about the only private equity players that are around – in most markets.

Public quotation – access to the public capital market – could be said to symbolise the New Economy. One needs to have the resources available for quick moves to facilitate growth which often involves M&A transactions. And one needs the same to attract and keep top management and employees. Publicly traded stock serves both challenges; it is the vehicle (i) to raise capital from the stock market, (ii) to merge with or acquire other companies, (iii) to build personnel incentive schemes, and (iv) to keep the management focused on core competence. In the "Old Economy," it was not unheard of that a venture was walked from idea to IPO without private equity money. Figure 1 illustrates the "lonely walk" of a prospective venture to IPO.

OWNERSHIP

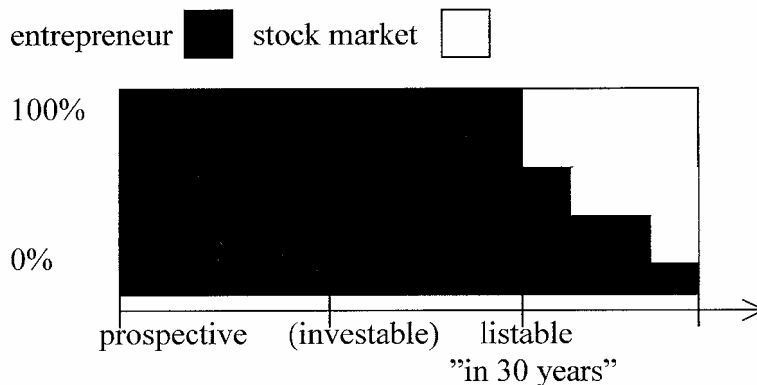


Figure 3: Playing solo – the lonely walk of a prospective venture to an IPO

In the New Economy, very few companies can build an access to the public capital market, i.e., reach a public quotation, without private equity finance – at least quickly enough. Private equity finance provides a "fast lane" to IPO. And, besides financing, private equity financiers often bring years or combined experience of building businesses to the equation. However, some of them have a better incentive and thereby willingness, along with a better ability, to use that experience than others. It is also worth noting that, carried across time, such an incentive is likely to exponentially increase both the willingness and the ability to be of contribution.

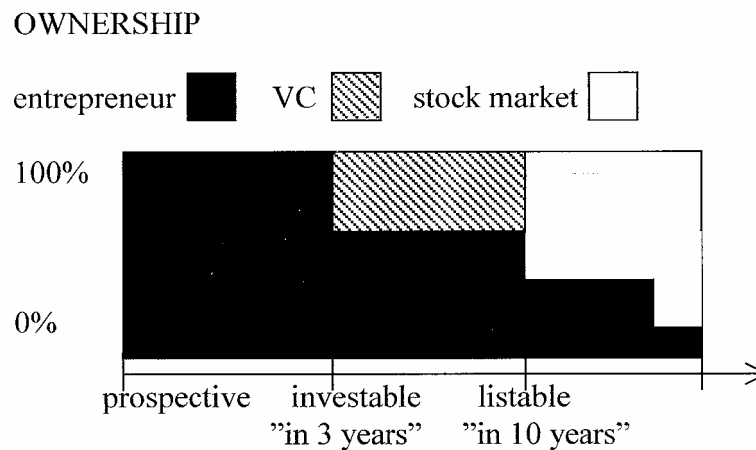


Figure 4: Pushed by VC – the fast lane of an investable venture to the IPO

Also, should a public company fail to meet its full potential or should there be any severe agency problems – this becoming evident from declining share prices (relative to industry average) – it is again the private equity players that take action. Without such watchdogs of mature companies, and without such financiers of entrepreneurial start-ups, economies are likely to severely deteriorate as demonstrated by economic experiments in Eastern Europe in the latter part of the 20th century. This is why this paper is focused on VC finance or, to be precise, V2C finance.

V2C Supply

The players that operate between entrepreneurial ventures and the formal venture capital industry, in efforts to bridge the capital gap, can be categorised as follows

1. business angels
2. incubators
3. advisers

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 organised growth of their business as do – for example – the players of the formal venture capital industry. In other words, they lack certain dynamism.

The same holds for many incubators, but from a different angle. Most incubators are based on a formal process and professional activity; this is someone's main job – not a mere hobby. However, whereas business angels personally participate as owners in underlying ventures, incubator staff seldom has 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.

Compared with business angels and incubators, advisers 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. Advisers are often faced with accusations according to which they do not care what happens in the client firms once they finished. On the more positive tone, advisers are highly skilled and motivated professionals who have seen many cases and can derive advise from experience. Also, advisers certainly work under market pressure, under pressure of profitability. This is neither a hobby for them, nor are they around to fulfil (soft) economic-policy-related missions.

DISCUSSION: THE WHO, WHY, AND HOW OF V2C

“Every enterprise needs a concept of its industry. There is a logical way of doing business in accordance with the facts and circumstances of an industry, if you can figure it out. If there are different concepts among the enterprises involved, these concepts are likely to express competitive forces in their most vigorous and most deciseve forms.” Alfred Sloan (Robert 1988: 20).

Both the capital gap and the capital heaven are good news to all of the above mentioned V2C players – business angels, incubators, and advisers. Capital gap means business for each of them. However, each player type seeks to utilise the capital gap in a different way, the implications of which have very differing consequences to the other stakeholders of the phenomenon, namely the venturers, the capitalists, and the society at large. Nonetheless, the width of the capital gap calls for efforts to create a new *professional* player. Figure 5 provides an illustration of the space for V2C to fulfil in the process of accelerating ventures from idea to IPO.

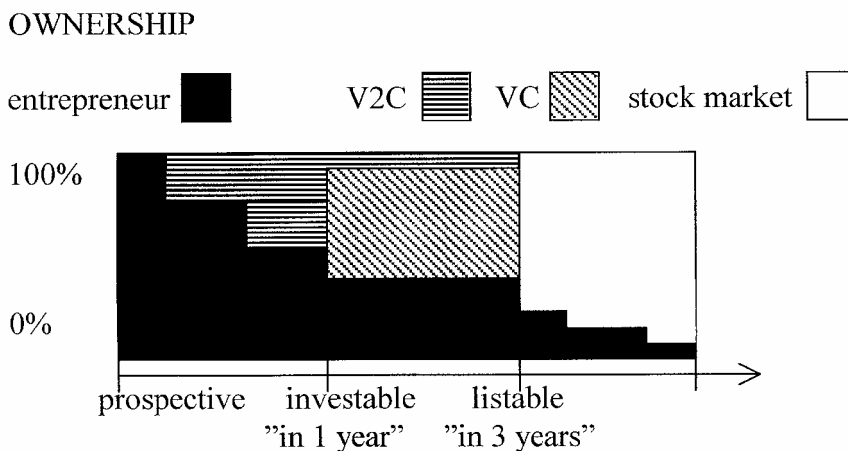


Figure 5: Accelerated by V2C – the fast lane of a prospective venture to the IPO

The Venture Survey Re-Visited

In four countries, the Venture Survey asked questions directly related to V2C services. This section produced altogether 21 responses from Finland, Luxembourg, the Netherlands, and Portugal. As many as 62% of those who responded reported they had considered raising “knowledge investment” – not mere capital investment. All of the Finnish respondents, none of the Luxembourg ones, one third of the Portuguese, and 40% of the Dutch respondents reported having considered raising “knowledge investment.”

We might call these knowledge investors “*knowledgists*” as opposed to capital investors or *capitalists*. List of different referrals included the following (number of instances in brackets):

- fellow-entrepreneurs (6)
- incubators (4)
- advisers (2)
- executives of large firms (1)
- corporate financiers (1)
- researchers (1)
- R&D teams (1)

This being an unorthodox concept and unorganized activity to begin with, it is no wonder many of the respondents addressed open questions with comments such as: “We do not know how to get this kind of support, how to find those who provide it.” The ones who had successfully raised “knowledge investment” from fellow-entrepreneurs had following arguments:

- “They invest brains and experience, the value of which is hard to evaluate in dollar terms.”
- “Money – per se -- is less meaningful than knowledge on how to spend it.”
- “Contacts and doors opened shape a firm’s future more than mere dollars on the balance sheet.”

When asked whether or not they would welcome a significant increase in the supply of V2C services, a compelling 71% of those who responded answered yes. Again, all of the Finnish respondents answered yes, while a half of the Luxembourg, a third of the Portuguese, and a half of the Dutch answered similarly. When asked whether they would be willing to search for V2C services via the internet, the respondents were split into two halves. Ten respondents answered positively and another ten negatively there being no significant variation between countries. The trend that strongly emerged through the open-end questions was a preference for personal contact with regard to attracting knowledgists. While (monetary) capital has no personality, knowledge comes “attached to such a thing.”

Perhaps the Internet could be utilised to create a platform and tool for *professional knowledgists* to attract *part-time knowledgists* for syndicated V2C deals and, eventually, *capitalists* for VC deals. Rephrasing Fried and Hisrich (1994): “Finally, one must ask: ‘How do the benefits that V2C players provide as intermediaries

compare to the costs'. While we show that the role of an intermediary is valuable, the [V2C] style of investing has high costs... More empirical work will be needed to explore in what situations V2C costs are justified.”

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