

Non-pecuniary contributions to the entrepreneurial process from venture capital

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Abstract:

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It is remarkable that both entrepreneurship research and innovation theory ascribe some of the key theoretical foundations to the same author, Joseph Schumpeter. Schumpeter (1911, 1939, 1942) provided both separate contributions to the theory of entrepreneurship and to innovation theory as well as providing a framework that integrated these two aspects. In his view the entrepreneur and the capitalist may well be two different persons or organisations. The role of the entrepreneur would be to break the established routines ("circular flow", 1911) by introducing innovation, but the financing of that process could be from external sources, in Schumpeters' terms denoted the capitalist.

The economic development process in society is dependent upon financing entrepreneurship, but also more specifically on the ex ante investment screening and the ex post monitoring and nursing of the investee firms. Both these processes require competences. Theoretically the relationship between entrepreneurship and the financing of the process has been described by applying models of asymmetric information leading into principal-agent problems (Myers and Majluf, 1984, Leland and Pyle, 1977, Stiglitz and Weiss, 1981, and numerous later models). Interestingly, the asymmetry is almost always described as an information gap on the part of the financier: the bank – or whatever financier – does not have as much information as the entrepreneur about the true nature of the entrepreneurial firm and the potential moral hazard of the entrepreneur. Therefore, the financier must put up incentive schemes to ensure alignment between interests of the financier and the entrepreneur. Even if this one-sided description may be sound enough, it is striking that this strand of theoretical development never turn the argument around. In fact, the competences of the financier are usually not easily known by the entrepreneur, there is a huge information asymmetry in the information available to entrepreneurs on the competences of the financier. Likewise, principal-agent line of thinking may be reversed: by accepting equity investor, thus often departing with influence, the entrepreneur could expect the financier to contribute with consultancy and other contributions. Thus, the research in this paper has important implications for entrepreneurs.

Schumpeter was aware of the importance of the non-monetary contribution of financiers, in particular when innovation is involved a close contact between financier and firm (capitalist and entrepreneur) becomes very important.¹

Following the theoretical considerations above, venture capital is viewed as a particular valuable source of financing of the entrepreneurial firm, because it combines capital and competencies. Although definitions of venture capital differ to some extent, then it is widely believed that venture capital involves not just passive finance. At the opposite, venture capital is often defined by a heavy involvement of venture capital firms (VCFs) in their portfolio firms. This involvement is a way to assist the development of the portfolio firm, something often particularly needed in relation to new,

¹ In a passage in his "Business Cycles" (1939) Schumpeter emphasizes the importance of a close contact between borrower and lender in the screening and monitoring function of the banker. Thus, the financier "...should know, and be able to judge, what his credit is used for and...the banker must not only know what the transaction is which he is asked to finance and how it is likely to turn out, but he must also know the customer, his business, and even his private habits, and get, by frequently "talking things over with him," a clear picture of his situation. But if banks finance innovation, all this becomes immeasurably more important."(p.90).

small firms. Such firms are often in need of complementing internal competencies, and venture capital firms may be one such external supplier of additional competencies.

Various aspects have been taken up in the venture capital research (an overview is in Mason & Harrison, 1999). On the involvement of VCFs the issues may be grouped into four; the degree of involvement, the content of the involvement, the impact of the involvement, and the factors that spur involvement. A number of studies have discussed what VCFs do, and how much they are involved (Reid, (1999), Elango et al. (1995), Ehrlich et al. (1994), MacMillan et al. (1988), Sapienza et al. (1996)). There is, however, little research on what is it on the firm side (other than mere strategy with the VCF) that make VCFs more or less involved.

The present paper focuses on three such aspects of venture capital involvement in a European country where the venture capital market is less developed and less matured. It reports empirical results on an investigation of the involvement of Danish venture capital firms in their investee companies. More precisely, it is discussed what is it exactly that venture capital firms add to a company except pure capital, how much are they involved, and most important - what determines this involvement.

Whereas the pioneering study on this issue by Gorman and Sahlman (1989), and several subsequent studies, answered the research question “What do Venture capitalists do?” By relying on the statements by the venture capital firms, the present paper takes another approach. The empirical research is based on interviews of portfolio firms rather than their venture capital financier. The data for the analyses was collected by firstly identifying all existing venture-backed firms in Denmark. In doing so we limited ourselves to only focus upon “true” venture-backing (Bygrave & Timmons, 1992), thus excluding firms financed by buy-out funds and other funds not having their main activities in venture capital, i.e. hands-on investments – mainly equity - in young, un-listed firms with high risk and high growth potential. Subsequently telephone interviews were undertaken with 121 of the 175 contacted venture-backed firms. The response rate was 71%.

The paper is structured as follows: Section 2 contains a short overview of existing empirical work focusing on the value added of venture capital. This review is helpful in developing the hypotheses for our own research. A priori it is expected that the degree of involvement may be related to variables such as ownership share, innovation, development of financial performance, size or age of the firm. A short linking to the theoretical considerations of the relationship between the parties is provided in section 3. Section 4 describes the data set including construction and methodological problems. Section 5 deals with qualitative effects of venture capital as seen by the portfolio firm. It does so by way of statistics and illustrative statements from the interviews. Furthermore it incorporates findings from similar surveys in Sweden, Norway and the UK. Finally, section 6 contains concluding remarks on the implications of the results and the limitations of the analyses.

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