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Tommi Rasila

# Venture-to-Capital - A New Framework for Growth Venturing and Professional Ownership

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# ABSTRACT


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The objective of this study is to build a theory of growth venturing as a practical phenomenon, contributing to the understanding of all interested parties: the owners and managers of the ventures, if not one and same person, also their financiers and other aides, such as business angels and advisors as well as the potential buyers of the companies and government policy makers, making decisions that shape the business environment.

The study starts by assessing the current theory of growth venturing by defining the elements it requires - Entrepreneurship, Equity Financing, Ownership and Management. Based in this extensive concept-analytical study, the theory of Venture-to-Capital as a new framework is synthesized from existing theory. The framework includes the operating modes, milestones and actors of the Venture-to-Capital arena. The reasons contributing to the need for the new discipline are also analyzed.

Next, the study seeks to modify and improve the theory of Venture-to-Capital by assessing and categorizing the operating models of both prevalent and emerging actors in the Venture-to-Capital arena. This empirical effort is based on 14 case studies as well as the analysis of the five existing actor classes – Advisor, Incubator, Seed Venture Capitalist, Business Angel and Business Angel Network. It is noted that due to the development and the change in the requirements for the V2C actors from the market and the target ventures, new kinds of actors have emerged alongside the traditional ones. As a result an improved, evolutionary classification of six different Venture-to-Capital actors is presented.

Further theoretical and practical implications of the findings are also presented, including a normative model of a V2C actor.



Keywords: venture-to-capital, V2C, entrepreneurship, venture capital, equity financing, equity gap, start-up company, NTBF, strategy, ownership management

# TIIVISTELMÄ

Tämän tutkimuksen päämääränä on luoda uutta teoriaa kasvuyritystoiminnasta käytännön toimintana. Se palvelee kaikkia osapuolia: kasvuyritysten omistajat ja johtajat, jotka voivat olla myös samoja henkilöitä; rahoittajia, kuten bisnesenkelit ja pääomasijoittajat; yrityskehittäjiä, kuten yrityskonsultit ja yrityspalveluelimet; yritysten potentiaaliset ostajat sekä julkiset elimet, jotka päätöksillään muokkaavat toimintaympäristöä.

Tutkimuksen ensimmäinen osa on käsiteanalyyttinen ja alkaa laajalla tutustumisella kasvuyritysteorian nykytilanteeseen käymällä läpi teorian neljä eri osa-aluetta: Yrittäjyys, oman pääoman ehtoinen sijoittaminen, omistaminen ja johtaminen. Näistä johdetaan uusi kasvuyritysteoria luomalla viitekehys kasvuyritysten eri vaiheiden toimintamuodoista, virstanpylväistä näiden välillä sekä kasvuun myötävaikuttavista toimijatyypeistä. Niinikään uuden teorian tarpeellisuuteen johtaneet tekijät ja syyt tuodaan esiin.

Seuraavaksi siirrytään empiiriseen osaan, jossa tapaustutkimuksen keinoin tarkastellaan 14 eri kasvuyritystoimijaa. Näistä löydetään yhteensä 21 erilaista toimintamuotoa, joihin analyysissa vielä lisätään vallalla olevat viisi toimijatyyppiä – hautomo, konsultti, bisnesenkeli, bisnesenkeliverkosto ja alkuvaiheen pääomasijoittaja. Vertaamalla vanhoja toimintamalleja ja niiden rinnalle syntyneitä uusia toimintatapoja luodaan kuusi toimijatyyppiä sisältävä uusi luokitus kasvuyritystoimijoille. Tämä uusi luokitus kuvastaa todellisuutta entistä luokittelua paremmin, koska kasvuyrityskentän toimijat ovat joutuneet muuttamaan ja kehittämään toimintatapojaan vastatakseen toimintaympäristön muutoksiin.

Loppupäätelmissä esitetään paitsi edellämainittu uusi kasvuyritystoimijoiden luokittelu, myös ehdotuksia kasvuyritystoiminnan kehittämiseksi sekä normatiivinen malli kasvuyritystoimijalle.

# ACKNOWLEDGEMENTS

*"It is not so much our friends' help that helps us, as the confidence of their help." – Epicurus*

Writing this dissertation has been an immensely interesting and instructive experience. Little did I know about the overwhelming diversity of the world I entered when starting this study, and even if I knew I hardly could understand it. The author, having earlier been a manager and an entrepreneur, had to learn new skills and practices, in fact a totally new discipline – that of a researcher. What a humbling experience, and a great education.

Now, when it is time to let this book off my hands it is also time to thank all those who have helped me during its making. First of all, of course, my supervisor Professor Juha Näsi, who seemed to have the infallible skill of improving any piece of text I showed him, and Dr. Marko Seppä, who contributed greatly from the very beginning – starting from the very concept of Venture-to-Capital. Closer to the final stages there were also two other distinguished scientists involved in the process as reviewers: Professor Richard Harrison and Docent Markku Lahdenpää. I make a deep bow to your direction and thank you for accepting the task as well as providing me with your comments.

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I would like to extend my gratitude also to those institutions who have provided financing for my work, which in chronological order are the Foundation for Economic Education or *Liikesivistysrahasto*, the Industrial Research Fund at the Tampere University of Technology or *TTY Tukisäätiö*, the Academy of Finland and the Research Programme for Advanced Technology Policy or *ProACT*. The support from eBRC was of crucial importance, as it was indeed the key enabler for the whole project. And I think we should all thank Virginia Mattila for proofreading this document. Just to think of it – before that I always thought my English was all right.

Additionally, there is a number of companies I have worked with as an advisor or board member while working on this dissertation. They have provided me with further first-hand experience about the importance of the V2C field. For this I'd like to specifically thank Jetico, Panphonics, Taipale Telematics, Kuusama Design and Hermia Business Development. The venture capital industry in Finland has also played a part in the process, and the people especially in 3i, Eqvitec Partners, Innofinance and FVCA have my deepest gratitude.

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Last but not least, my family. Thanks, mother and father, for not being satisfied with only three children - I hope I have been able to live up to your expectations. At any rate, I am truly happy to have accomplished this task, as my father did tens of years ago. Thank you, Leevi, Valtteri and Eino, for being there for your father and hence reminding me of what is really important in life. And thank you, Heidi, my beloved muse, for your pride in me has given me so much strength and vigour. I hope to be able to pay this back to you in the forthcoming years.

Tampere, 6th September 2004

Tommi Rasila

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# 1 INTRODUCTION

*"Not all who wander are lost." - J.R.R. Tolkien*

## 1.1 Background

The world is full of possibilities for putting together a company. The number of promising companies is flourishing due to availability of opportunities, low inhibitive barriers and the encouraging examples of other entrepreneurs. This is very welcome, since Western societies need small companies to be founded and developed to substitute the loss of jobs in smokestack industries. As noted by Drucker (1994), the Fortune 500 companies and other big institutions in the US lost some five million jobs between 1965 and 1985, yet at the same time small and medium sized businesses created 40 million more, which not only compensated for this loss but also occupied the baby-boomers and married women, who were getting paid jobs at growing pace during that era.

For the majority of entrepreneurs their appetite for success is satisfied if the business is able to bring them their daily income. There is also another group of entrepreneurs, who see potential for high growth in their companies and want to utilize this potential both to develop the business and make its value grow. These companies may become substantial players in fast-growing or turbulent markets by being in the right place at the right time. And conquering the market may happen fast: Compared to earlier success stories such as IBM or Hewlett-Packard, Microsoft and Intel were fast but still took years to build up, while Dell and Amazon are much closer to overnight success.

These companies need outside resources and capital investments to fully utilize their growth potential, as they can grow faster than what can be realized using their income and own resources alone. The prevalent answer to this is Venture Capital, which has become a mature industry during the last decades (see Chapter 2.2.3). What used to be a mysterious game of insiders is now a well-established business, aiming to facilitate the birth and growth of ventures. The message we hear from the VC companies in general is that every viable company will obtain funding as long as it can show the seminal Team, Product and Market. If the prospective company is prominent in these three factors, it will supposedly receive VC funding and – guided by the VC - travel along the yellow brick road towards the Initial Public Offering (IPO), making it eligible for financing from the public market. This, however, is not the whole truth: many promising ventures are still unable for a number of reasons to obtain the financing and outside expertise they need for growth.

First, private equity is shifting from traditional venture capital towards capital-intensive later-stage investments, such as Management Buy-Out and Leveraged Buy-Out (MBO and LBO) transactions, thus leaving smaller end capital needs unattended. The minimum investment limit of formal VC companies has in some cases been as high as USD 5 million (eForum… 2001). The seed and early stage investment needs are not satisfactorily catered with the informal seed capital in form of the so-called “friendly money” from the inner circle of the founders or even informal venture capital provided by Business Angels (see Chapters 2.2.1 and 2.2.2 respectively). Hence, the prospective companies suffer from effect of the *Equity Gap* (see e.g. Dominguez 1974, Bannock 1991, Lonsdale 1995, Cartwright and Orpen 1997, Bushrod 2002c and 2003).

Furthermore, many new companies are founded by technology innovators, who - despite being experts in their technological field - often lack the skills needed in the business environment. Studies show a growing concern among entrepreneurs that in addition to the capital injection the companies would need expert advice, which is sometimes considered to be even more important than money (see e.g. Harrison and Mason 1992, Murray 1994, Seppä 2000, eForum… 2001, Gladstone and Gladstone 2002). Various support mechanisms exist to remedy this inherent deficiency of fledgling companies, ranging from entrepreneurship classes in all major universities to government-subsidized incubators with support services. Still, it can be argued that the mechanisms are far from perfect: many incubators, venture capitalists and other actors are unable to contribute the added value they are expected to provide. Therefore, many a promising company fails unnecessarily, not for lack of funding but for lack of business skills which they do not possess and others are unable to provide. Thus, we may say that a *Competence Gap* exists side by side with the Equity Gap.

The most evident answer for crossing the Competence Gap and Equity Gap is informal venture capital in the form of Business Angels and angel investing. By the *de facto* definition, business angels are wealthy individuals with abundant experience and expertise in various fields, making considerable size seed and growth investments to small companies. Along with financing, they are in the best case also able to contribute to the management of the company by means of board work, consultation and their network of contacts. In the most established business angel countries such as UK and USA they account for far more private placements than does venture capital, both in number and total value of investments. They should be considered as a major force in the game, even though they may be less known to the public. This is due to their habit of operating with a low profile, which is done for a good reason: So as not to attract excessive amounts of investment proposals. Not to mention begging letters - some people regard a business angel as simply a wealthy individual giving away money. The adverse effect of this is that business angels are also hard to reach for those who are in need of them, and whom they would like to see.

Various matching services and Business Angel Networks (BAN) try to overcome this mismatch of supply and demand by gathering a number of investors together and exposing incoming venture deals to them. These systems show good results in many places. Unfortunately the networks are not ubiquitous and matching services work well only if they have good coverage of both ventures and investors. Therefore, ventures say they do not find funding while at the same time the business angels say they would make more investments if only they could find suitable companies to invest in (Wetzel 1983, Mason and Harrison 1999, 2002a, 2003a). We may say that a third gap is found: *The Matching Gap*.

All this shows that the environment of a growth-oriented start-up venture does not work perfectly. This is of course a safe assumption by nature, as there can never be a perfect market. Nevertheless, we can evince two arguments based on this assumption:

- there are companies, which could be made successes with suitable assistance but fail because of the discrepancies of the environment and its actors.
- the actors in the current market do not serve the existing demands perfectly.

From these two arguments we can deduce that another form of operating in this area could be found, which would provide better results.

The aim of this study is to improve our understanding of growth venturing by creating a new framework for it. This new theory, Venture-to-Capital, will look at growth venturing as a single phenomenon, combining several elements which are its pre-requisites. Different factors of entrepreneurship and management can be seen as elements internal to the growth venture, enabling and facilitating the growth. At the same time, private equity financing and participative ownership can be regarded as shared entrepreneurial risk and professional ownership, aiming to increase the value of the venture and hence the ownership position.

Once the framework has been defined, the study continues by looking at the operating models of the actors assisting early-stage companies. Analyzing the practices of both prevalent types of actors as well as emerging ones and logic behind their actions will enable us to assess what works and does not work in practice. Then, based on these findings we synthesize recommendations and a normative model of an actor to assist the practitioners to improve their operation. After all, “those who strive for excellence will help us all to meet the challenges the future will bring” (Allen 1994).

It should not be expected that there would be one single method or process, which could be used to make every company a success story. The companies, markets and economies are very different, and as noted earlier not all companies are interested in high growth in the first place anyway. Still, facilitating the growth of companies wanting it is worthwhile. Principally, improving the growth venturing process is beneficial for all parties involved: ventures, assisting actors, formal and informal financiers as well as employees and economies in general.

## *1.2 Research Questions and Objectives of the Study*

The main objective of this study is to *build a theory of growth venturing as a practical phenomenon*. In order to accomplish this task, it has four distinct research objectives:

1. Assess the current theory of growth venturing by defining the elements it requires: Entrepreneurship, Equity Financing, Ownership and Management.

2. Synthesize the theory of Venture-to-Capital as a new framework from existing theory of growth venturing.

3. Modify and improve the theory of Venture-to-Capital by assessing and categorizing the operating models of both prevalent and emerging actors in the Venture-to-Capital arena.

4. Present theoretical and practical implications of the findings, including a normative model of a V2C actor.

The research questions are summarized in the following table.

Table 1: Research Questions

| Main objective:<br>Create a new framework for looking at growth venturing process as a single practical phenomenon. | | | |
|---|---|---|---|
| *(Chapter 2)* | *(Chapter 3)* | *(Chapter 4)* | *(Chapter 5)* |
| *What are the elements and requirements of growth venturing?*<br>- *Entrepreneurship*<br>- *Equity financing*<br>- *Ownership*<br>- *Management* | *Based on existing theory and practices, build the theory of Venture-to-Capital:*<br>- *V2C framework*<br>- *V2C actors*<br>- *V2C arena*<br>- *V2C challenges* | *Assess and categorize contemporary V2C actors and compare them to the prevalent actors:*<br>- *Multiple case study*<br>- *Evolutionary taxonomy of V2C actors* | *Based on the findings in theory and in practice, how can the theory and practice be improved?*<br>- *Normative model of V2C actor*<br>- *Implications on V2C and VC practices* |

Of the many definitions of theory (see e.g. Niiniluoto 1083, Haaparanta and Niiniluoto 1986, Uusitalo 1991), in this study theory is seen to be a system of clauses defining the associated concepts and their relationships. In our case theory is seen as a necessity both as a framework for analyzing the prior knowledge on the subject as well as arranging the resulting propositions in a logical ans systematical way (Uusitalo 1991).

This study contributes to understanding of growth venturing for each key stakeholder group. Besides the *owners* and *managers* of the ventures, if not one and same person, also their *financiers* and other *aides*, such as business angels and advisors as well as the potential *buyers* of the companies and *government policy makers*, making decisions that shape their business environment.

Reaching conclusive data or creating a universal model is not the purpose of this study. Rather it is to improve understanding of the Venture-to-Capital arena and its operatives further. After all, this dissemination merely scratches the surface and opens V2C for successive research by defining its boundaries and creating the terminology for it. The ulterior motive and hope of the author is, that while improving understanding the study also promotes improvements in the industry, a goal which is in accordance with the hermeneutic philosophy used.

The impact of any study on practice depends ultimately on practitioners. The business practises synthesized in the end of this study are formulated according the practical syllogism, a model of intention formulated by von Wright (1971). The formulation process also complies with the idea of technical norm, which is principal to the normative research (Olkkonen 1993), even though the model itself tries not to be normative. Yet, both of these principles base their outcome on wants and beliefs. It is up to the practitioners in the field to decide whether they adapt these practices or not, providing the ultimate acid test to the results.

## 1.3 Scope and Structure of the Study

A major part of the dissertation at hand is contributed to developing a new concept called Venture-to-Capital[1]. The term refers to a conceptual area between the venture and capital. In general, the aim is to take more nascent and newborn companies over the troubled waters of early stage venturing to

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[1] The term Venture-to-Capital was coined by Dr. Marko Seppä, with whom the author has been developing the concept since 2001.

the hands of venture capital investors. There are many challenges to this, including finding and selecting the ventures to be worthwhile, and developing them to a state where they meet the requirements of VC investors. Nevertheless, in the context of this study the goal is defined to be commonly beneficial; entrepreneurs need investment, financiers need investee companies and society at large need the jobs and economic growth provided by successful SME companies boosted with VC's.

The Venture-to-Capital concept, or V2C for short, falls between and among existing theories of entrepreneurship and ownership on the other end and venture financing and management in the other. To assist in defining the V2C space and generating terminology for it, these questions are assessed in the literature study to formulate the theoretical basis for the new concept. Many other theories can be seen to be relevant to the topic as well, but for practical reasons the number is limited. Concept and terminology of Venture-to-Capital is thus to be laid down to assist future research to tackle upcoming questions better and to improve both researchers and practitioners to better understand the dynamics of this area – new venture creation and development.

Scope of Venture-to-Capital - and therefore of this study - starts from a somewhat vaguely defined stage in the company's development called either Idea or Concept. This may be a distinctive new invention, result of years of work in a university lab, or it may be The Bright Idea as defined by Drucker (1994): clever-looking but risky, it may be a new product innovation emerging to someone while commuting in a bus or an innovative business idea created by an executive in a large corporation, just waiting to be spun off. In all cases, the idea has to survive from this moment on. Yes, there are government offices and law firms to assist the new entrepreneur in formation of the company, and guidebooks describing where one should call for financing and emphasizing the importance of good team and thorough market research, among other good advice. But Venture-to-Capital goes further than this; we want to see to it that the venture is taken from its initial idea stage all the way to the pearly gates of venture capital investment, the pre-defined measure of success in this study.

Since venture capital is already well defined and researched area, we end the scope of Venture-to-Capital and therefore this study to the moment when the company is eligible for VC funding. From this point its financing needs can be catered by means of institutional investment market such as formal venture capital and later also banks and public stock market. Naturally, the company can either take the investment or choose to continue its life as a now well-established private company. Trade sale or getting funded by other sources than VC are alternatives for the company as well, but nevertheless in the scope of this study and its V2C context a company "worthy for VC investment" is defined successful. Since VC investment is defined to be the goal of a venture as examined in this study, we concentrate on growth-oriented companies. These inherently need outside financing to finance their growth, which is faster than the organic growth that can be supported by the income.

To conclude with, the first part of this study, consisting of chapters 2 and 3, is concept-analytical, aiming to generate new paradigm and terminology. Therefore, we make a broad look at several theories and concepts close to our focus, looking at a growth-oriented company from various perspectives. These include aspects from entrepreneurship, financing, ownership and management.

We continue to laying out the Venture-to-Capital framework in chapter 3 by making a historical overview on development of business venturing and venture capital. What happened to venture capital industry, which was originally established to unlock the potential of growth ventures, i.e. to exploit the win-win scenario of backing up promising companies in their early stages and facilitating their success? What are the current imperfections in the financing market between the informal and formal capital market, i.e. where the friendly money and business angels end and where the VC money starts, and its implications on new business venturing? When answering these questions we see the new paradigmatic concept surfacing: Venture-to-Capital, the area which is stretching between the ventures in seek of capital and the venture capitalist seeking for the ventures. Eventually, this chapter defines the Venture-to-Capital area and terminology and delineates its connections with the existing theories. It also evaluates the business models of actors who are currently predominating the area: Incubators, Advisors, Business Angels, Business Angel Networks and Seed Venture Capitalists.

The second part consists of two separate efforts, in which both traditional and emerging V2C business models are analyzed side by side. First, a multiple case study is done in chapter 4 on fourteen entities representing emerging V2C actors, which have basically evolved from the traditional ones. These result in 21 operatives, as the actors and affiliates of one entity can have several roles. The result is comparison of twenty one new actors and five prevailing actor classes, differing more or less from each other. Based on this, a more contemporary version of the taxonomy presented in the previous chapter is created.

After this, the V2C actors are discussed to seek for answers to a number of questions: What are the constraints of different actors, impeding their ability to work effectively with early-stage ventures? What do these operatives do that works, and what does not work no matter how they try? What were the changes leading to evolution in the market and its actors? And ultimately, can we predict the end result of this evolution in advance, by defining a normative model or models for practitioners in this field? The suggested improvements on practices are presented in the subsequent discussion in chapter 5 together with a normative model of the Venture-to-Capital actor. As it is not possible to test the suggested business practices in real world within this study, the testing is out of the scope of this study and the underlying model is presented as a conceptual construction.

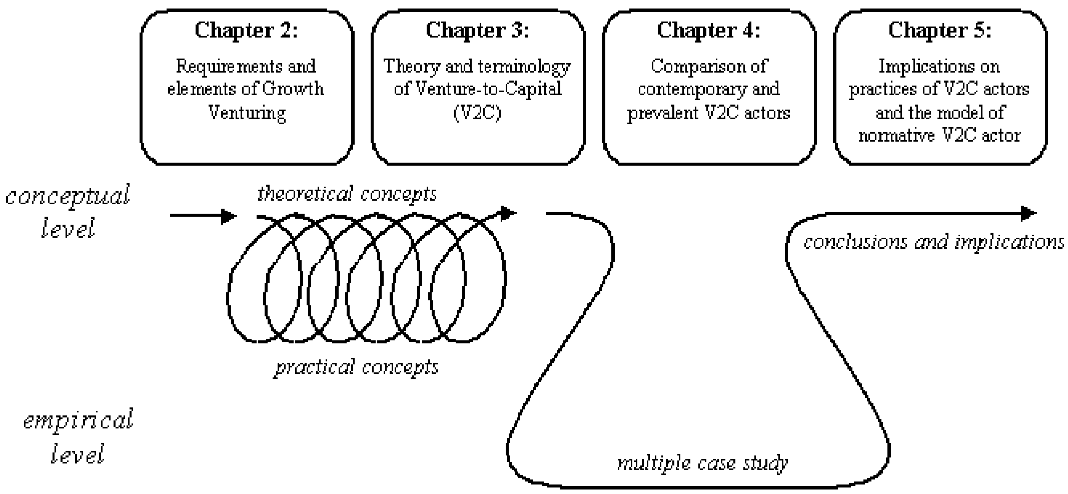


Figure 1: Structure of the Study

The structure of this study in Figure 1 illustrates its multi-faceted and challenging approach. The study draws from both scientific literature and informal writings and articles; theoretical concepts as well as practical ones, and first-hand observations and interviews especially in connection with case studies. The research metohodology applied in various stages of the study and the philosophy behind these decisions is discussed in more detail in the next chapter.

## 1.4 Research Methodology

### 1.4.1 Appropriating the Need for a New Concept

Research paradigm for the first part of this study is concept-analytical. It studies the basic assumptions behind constructs, analyzing the theories, models and frameworks used in previous empirical studies and applying a logical reasoning thereafter (Järvinen 2001). Hence the first part starts with a literature study in chapter 2 followed by the logical reasoning which creates a new framework for growth venturing called Venture-to-Capital in chapter 3. The literature study offers an overview on four major theories, each one of which contain several sub-theories. The resulting theoretical framework will form the basis for formulation of the concept and terminology.

The need and justification for the new approach can be explained by two perspectives. First of all, all theories have been new when created. Like Venture-to-Capital, they may have seemed oddly familiar when introduced. Indeed, there is nothing new in Venture-to-Capital: no new innovation[2], no new environmentally friendly energy supplies, no perpetuum mobile. Just old things called by new names. But this is just as it has always been: having a new approach to a phenomenon. To exemplify this, the terminology creation phase is preceded by historical perspectives to the inspected phenomenon. This provides comparison between past and current practices, showing that very little new has been invented, and that e.g. venture capital and business angels have existed long before they were called with these names.

Secondly, we can reflect the findings of Kuhn (1962) regarding the evolutionary stages in scientific paradigms. In "normal conditions" the scientific community binds itself to shared research principles and common research program. At this stage the goal is in making more accurate observations, combining these observations with theory and applying theory to new areas. At some point, controversy is found between the theory and reality. Trying to adapt to these anomalies complicates things further, creating a scientific crisis. (Niiniluoto 1983)

his leads to the old and established research program being replaced by a new one, after which a pre-paradigmatic phase follows. At this stage, the definitions are vague and there are competing theories. The overall doubt about the real status and situation continues until the community is again ready to commit to shared research principles and start the cycle all over again. The following illustration depicts these stages defined by Kuhn.

[2] In narrow sense of innovation.

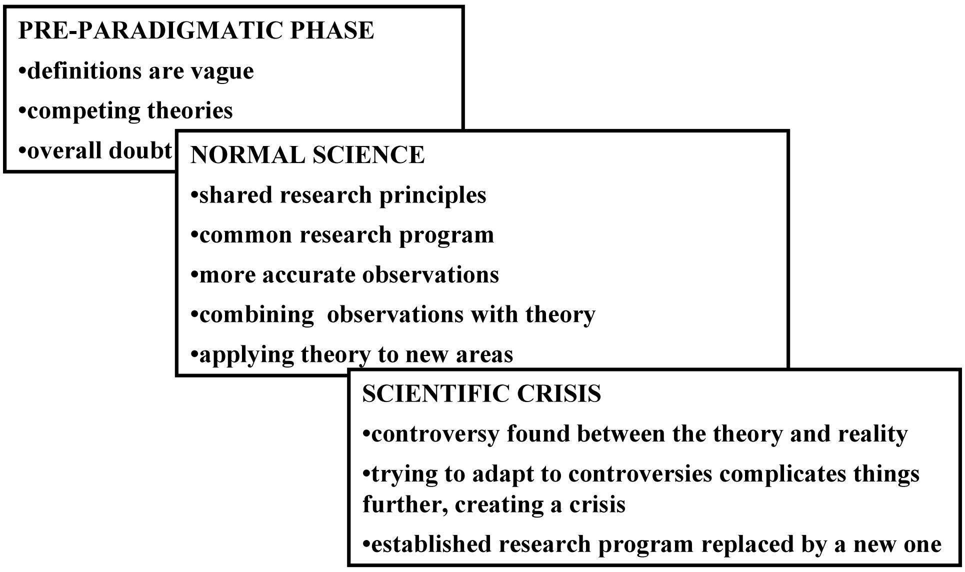


Figure 2: Evolutionary stages in scientific paradigms. (adapted from Kuhn 1962)

In the context of this study we may claim that there is no applicable theory covering the substance of Venture-to-Capital and thus a revolutionary step in science is required. As the result we have the "pre-paradigmatic" phase of Venture-to-Capital as a scientific theory. And indeed, in accordance with observations made by Kuhn, the definitions are vague and there is doubt about sensible starting points and research questions. These are the very reasons justifying the first part of this dissertation, which is an effort to create definitions for the theory.

The research paradigm in this part, as noted earlier, is conceptual analysis, aiming to creation of new concepts and definitions. The use of this paradigm is typically based on earlier similar research or empirical study, and it uses analysis and synthesis to construct new conceptual structures. There is no real verification of results in this research strategy, but the synthesis, analysis and verification is done through thinking and argumentation (Neilimo and Näsi 1980). Orientation of conceptual analysis is considered to be theoretical and descriptive (Kasanen et al. 1991, Uusitalo 1991) although the result is normative in nature, presenting one approach for mastering the development of the research question (Olkkonen 1993).

Process of creating new concepts and definitions is called scientific conception. In the empirical tradition the method of realizing this are abstraction and association; from red entities one can abstract the concept of *red* and from ideas of the upper body of a human and lower body of a horse one can form the concept of a *centaur*. These new concepts are tools for interpreting the experiences for attaining knowledge about the reality. According to Whewell, the concepts should be exact, accurate and well bounded, yet the terms are constantly modified in science in order to express theoretical hypotheses better. Thus, the terms should be constructed and operationalized in a way which allows them to be used for expression of true and general sentences in a simple manner. This proposes four goals for conception: simplicity, clarity, generality and truthfulness. (Niiniluoto 1980)

Cohen and Nagel give four requisites for definitions:

1. definition has to express the essence of the defined
2. definition must not be a loop definition
3. if possible, the definition should be done using positive expressions
4. definition must not be expressed with unclear or figurative language

Essentially, requisite two above means in practise that no study can in itself define all the terms used. Therefore, some terms have to be chosen to be primitive terms, from which all the other terms are defined. Third requisite is not imperative, but suggests that defining should be done by defining what an entity is rather than what it is not. Yet, it is sometimes beneficial or even essential to express definition using negative terms, as in the case of freedom, which can be either positive (freedom to do something) or negative (freedom of not being imprisoned). The most important requisites in this study are the first and fourth item in the above list; the definition has to express the essence of the defined using clear terms. (Niiniluoto 1980)

### 1.4.2 Building New Theory on Case Studies

Second part of the study focuses on Venture-to-Capital actors: past, present and especially future. The traditional, prevailing classes of actors are well known and studied. Therefore, explaining them in detail is an extension of the literature study and based on a five-category taxonomy based on an example of earlier research. The present, or rather emerging types of actors are studied in chapter 4 through a number of case examples, forming the empirical basis of this study. The cases are selected so that each one offers something new and innovative compared to the traditional actors.

After case descriptions, their operating models are assessed and a more contemporary, evolutionary taxonomy is created. This categorization forms an evolutionary step ahead from the earlier one, as it includes the traditional classes of Venture-to-Capital actors but also adapts to the emerging newactors. Finally, based on the strengths and weaknesses found in assessment of the past and present types of actors, an effort is made to formulate best practises for V2C actors in general in chapter 5. Also, a normative model of a V2C actor is presented, based on findings of the previous chapters. As creating the winning business model is not the task of this dissertation, these should be regarded as suggestions from which practitioners can draw new ideas for their businesses.

When going into philosophical backbone of the second part, we note that the methodological starting point in analyzing the new business models is the case method. Secondly, the research approach is hermeneutic and descriptive in contrast of positivistic and normative. The hermeneutical approach accepts interpreting observations of a relatively small sample, using researcher as a tool. This is often the case when the phenomenon to be studied is new and there is little research material and cases available. Furthermore, the goal of the whole study is to generate descriptive data: new definitions and classifications, describing processes, explaining correlations and causalities and improving the overall understanding of the subject (Olkkonen 1993).

Case studies can be divided in three categories: explanatory, descriptive and exploratory (Yin 1994). The approach of this study falls to the last category of these, which Gummesson notes is the most demanding and often looked on with scepticism (2000). Indeed, trying to explain a phenomenon by use of one or two examples would be vague. Therefore we look at fourteen case examples in this study, each one of them having at least one unique factor in their business model or operation.

The cases have been picked using the comparison method introduced by Glaser and Strauss (1967). Known as theoretical sampling this method calls for choosing cases that represent different aspects of reality. It is an ongoing sampling process in which the researcher simultaneously collects, codes and analyses the data, making decisions on where to collect the next sample based on the earlier results. For example, cases can be chosen because of suspected intrinsic differences between them (Gummesson 2000). The sampling is stopped when saturation is achieved, i.e. the marginal contribution of each additional case approaches nil (Glaser and Strauss 1967).

Thus, the population of this study is designed to be heterogeneous and geographically spread to give a good overview of the observed phenomenon. Still, the semi-unsystematic selection of case examples brings forward the question of validity and reliability. However, the number of examples is considered to be adequate to surface all relevant aspects of the phenomenon. In other words, simply rising the number of case examples would not yield in considerably more information of the known aspects and thus saturation point is reached. Furthermore, the key precondition in electing a case was that it had to contain a unique feature, and at the time of conducting the field study, there were no further notable examples with such quality known to the author. Thus, the empirical data can be considered to be representative of the phenomenon.

Since the case examples represent several subclasses, we should also address the question of generalization. In order to justify any degree of generalization, there should be several cases in each category or subclass. On the other hand, Gummesson (2000) points out that the mere number of cases observations does not necessarily translate to results with high reliability and validity. A limited number or even one in-depth study will help in identifying and understanding phenomena which can also be found in other companies. And after all, no matter how big the sample, a model or theory can not be proven right anyway – only wrong (Popper 1959).

A variety of methods were used in obtaining information about the case examples. Most productive sources of information were the websites, marketing information and press releases provided by the operatives themselves, together with news articles published in magazines, newspapers and on-line publications. For some there were also academic articles or other literature available. In most cases the survey was also supported by unstructured interview to find out the latest information, check the existing data and fill the gaps in information. This multi-faceted approach in gathering information about the reality is supported by literature on qualitative methods (Glaser and Strauss 1967, Arbnor and Bjerke 1997, Gummesson 2000).

In his book about qualitative research Alasuutari (1994) implicitly refers to the research question as *the riddle*, when using phrase *solving the riddle* instead of *interpreting the results*. In order to solve the riddle, we need to construct the mutual framework for the actors observed, and be prepared for new questions to rise during analysis. This strikes a chord with our goal of finding out the answer to our research objectives as presented in chapter 1.2. With the aid of the case examples we hope to solve the riddle and find out, what works in the current business models and what does not, aiming at generating suggestions towards an improved business model.

In regard to creating this improved business model for future, Seppälä notes in his article about methodology of futurology that being first introduced to futurology is perplexing to a person used to mathematics and natural sciences. Is it research or science or should it be called pondering or conjecturing? Nevertheless, he points out that the best approach in obtaining information about future is to observe the present moment, just as researching history is done with current documents, artefacts and other traces left from the past. Researching both history and future is done through researching the present moment. To explain this we think of a seed: when looking at a seed we can conclude from history which kind of tree will grow of it. (Seppälä 1985)

This is done when analysing the traditional and emerging Venture-to-Capital business models. The following illustration by Gummesson (2000) depicting pursuit for understanding through use of own pre-understanding and experience of others complies well with the research strategy of this study. It is based on his view of continuous development alternating between pre-understanding and understanding called the Hermeneutical Spiral. In this study, experience of others comes in form of existing business models, which have or are been tested in real life conditions. Obtaining information about these experiences of other and combining it to pre-understanding and personal involvement provides improved understanding of the subject.

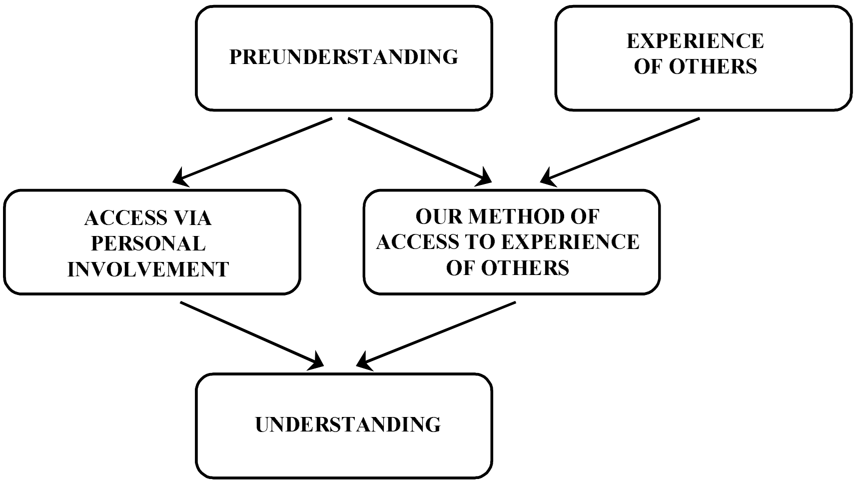


Figure 3: Sources for Understanding (Gummesson 2000)

The adapted interpretative approach to reality and trying to understand it using both facts and values is characteristic to hermeneutical approach. After all, the very word “hermeneutics“ supposedly comes from the Greek god Hermes, who interpreted the deeds and thoughts of the Gods to the laymen with their own language and words (Niiniluoto 1983). This is in contrast with positive approach, relying on explaining reality with hard facts and promotes staying distant and impartial to the phenomenon observed, separating values from facts and intellect from emotion (Andersson 1979)

Efforts to analyse and compare the case examples through positivistic methods would be in vain, as there is little scientific and hard data available from these objects (Seppälä 1985). Furthermore, even though there has been preliminary effort to generate means for performance measurement of these actors, putting them in order based on some sort of quantitative data is not straightforward at all (Jungman et al. 2002 and 2004). Thus, the researcher is pushed to using his own personality and pre-understanding in obtaining and interpreting the data as an observer or observer-actor, sometimes also referred to as observactor (Arbnor and Bjerke 1997).

# 2 REQUIREMENTS OF GROWTH VENTURING

*"Theory need not be a positive doctrine, a sort of manual for action. It is an analytical investigation leading to a close acquaintance with the subject." – Carl von Clausewitz*

The purpose of this chapter is to assess the current theory of growth venturing. For this, we make a broad look at several theories and concepts close to our focus, looking at a growth-oriented company from various perspectives. These include aspects from entrepreneurship, private equity financing, ownership and management, which are considered the key elements of the growth venturing discipline.

## *2.1 Outlining the Theoretical Framework*

Developing new growth businesses is a multi-faceted phenomenon. Its theory draws on many paradigms and disciplines. In the very heart we can see *Entrepreneurship*, bringing a person – entrepreneur - with an idea to the locus of our interest, aiming to form a company around his innovation. In a growth-oriented business, the entrepreneur needs funding first to start and then to develop and grow his venture, bringing up the second discipline: *Financing*. These two together already *per se* suggest a third paradigm, *Ownership,* examining the possible interest of the entrepreneur(s), financiers and other stakeholders in the company.

Besides having a key person or persons as entrepreneurs with adequate financing and commitment through ownership among the stakeholders, the new venture still needs good *Management* to succeed. Regardless of the business idea or the perceived or actual lucrativeness of the market, the venture will fail if the execution is bad. There needs to be a strategy, a capable team to operationalize the strategy and an array of management tools to perform this task. The set of business skills needed in new technology-based firms (see Chapter 2.3.3) is a multidimensional collection of practices and disciplines, and quite different from the somewhat narrow-minded views presented in traditional strategy and management literature targeted mainly to management of established companies and industries.

The discipline for the growth venture process lies in the void within or in the center of these paradigms – Entrepreneurship, Financing, Ownership and Management. It concentrates on development of growth-oriented businesses, from new venture creation towards an established market position through various financing and managerial stages. The apparent need for a new discipline was suggested already more than a decade ago by Näsi (1990) as shown in the picture below.

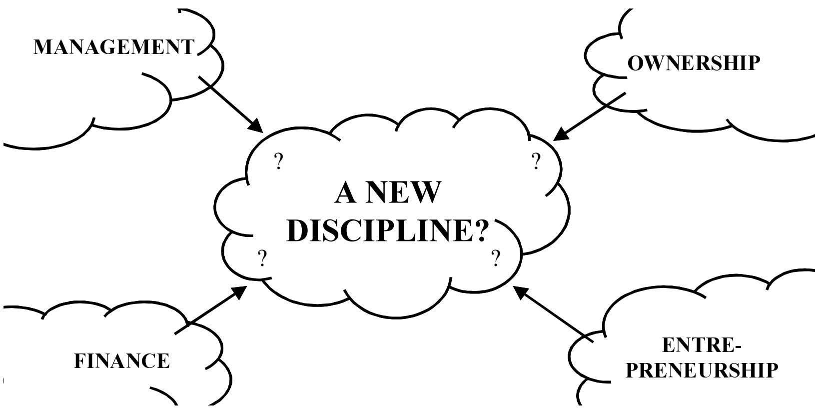


Figure 4: Towards a New Discipline (Näsi 1990)

As noted by Näsi, the new discipline would be a small but a particularly interesting sector, needing its own concepts, theories and methods from all the four "parenting" paradigms. To achieve this, all four paradigms are examined in the following to lay the foundation for the new discipline. Thus, the following four subchapters, from 2.2 to 2.6, will present literature reviews of the four originating paradigms leading towards the new one.

Within each paradigm, several concepts or sub-disciplines are analyzed to paint a full picture of the phenomenon studied. Furthermore, the paradigms may be limited on purpose, in which case the limitations are presented at the opening of the chapter in question. The literature review is followed by a synthesis in Chapter 2.6 presenting the new paradigm briefly on conceptual level, as more profound constructive work will follow in the next chapter.

## 2.2 Private Equity Financing

*"So then we went to Hewlett-Packard and they said 'Hey, we don't need you. You haven't gone through college yet.' " – Steve Jobs*

All new companies need financing to start up their operation. A starting self-employed consultant may have most of the tools readily available, but even the smallest new shop needs some money to pay the rent and buy furniture, as well as working capital to buy the goods. For a high-tech or bio-tech start-up the amount of investment needed is far greater, as it may take several years until the product is finished, after which the market still has to be conquered.

Thus, the amount of financing a new venture needs varies greatly, and so do the sources for it. For the shop, the founder may get a loan against his house as collateral. In many countires, state-subsidized and –guaranteed loans as well as grants are available e.g. as a part of a program promoting entrepreneurship and self-employment. Founders may also pool their money and raise informal seed capital from families and friends; the so-called friendly money, or 3 F's for Founders, Families and Friends. But until the company has reached a certain level of maturity and/or profitability, there is no way to get more loans from the banks without collateral, as they are not risk-takers. Hence, when the personal resources and those of families have been exhausted, the only alternative is to turn to the parties who offer equity financing with risk more or less as their profession: Business Angels and Venture Capitalists. For a depictive illustration see Figure 5.

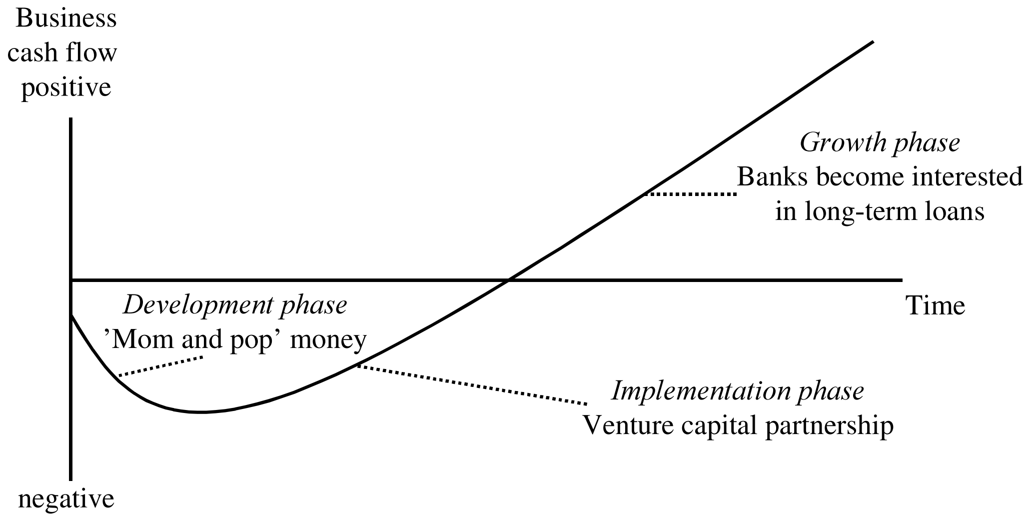


Figure 5: Early Stage Business Finance (Bridge et al. 1998)

The illustration also reflects the thinking of Wetzel (1983), according to whom the market for risk capital consists of at least three segments, each having a distinctive set of characteristics: 1) The public equity market; 2) The professional venture capital market; and 3) The market for informal risk capital (business angels). Given that he says that the boundaries separating these segments are indistinct and often overlap, this is potentially contradictory to his notion in the same article that founders, friends and family (relatives), i.e. the 3 F's, are not business angels. After all, their contribution to risk capital pool is substantial and cannot be neglected. Therefore, either they have to be included in the informal risk capital or listed separately as we do in the following chapter.

During the past two decades the environment of finance has developed and diversified greatly, especially due to the strengthening of the stock market and the positioning of venture capital. Better availability of equity investments has dramatically improved the possibilities of innovative companies representing high risk to the investor and who were – and are – unable to get funded by the banking sector. (Hyytinen and Pajarinen 2003)

Still, the equity investment market, consisting of informal and formal venture capital[3] and stock market, forms a grey area working inefficiently from the viewpoint of growth companies. Developing that market in a way which would integrate the different counterparts into a continuum might be beneficial for all. From the economic point-of-view it would be especially important to improve the early-stage funding segment, consisting of informal venture capital in the form of business angels and formal venture capital as seed VC funding. (ibid.)

After all, it has been noted that banks have become ever more risk-averse, and venture capital funds – previously only of marginal significance – are now concentrating their investment on more established companies. Also, management buy-outs and buy-ins and pressures to reduce government spending have resulted in a reduction in public policy initiatives. In this context there is a growing interest in the role of the informal venture capital market as an alternative source of risk finance for small businesses. (Lumme et al. 1998) Unfortunately, informal VC is almost inherently

[3] Also known e.g. as organized and informal private equity market (Prowse 1998)

inefficient as a market, as business angels tend to avoid publicity to be able to choose whom they address – a problem to be discussed in more depth later.

We will now have a look at all forms of early stage equity financing. The first to be analysed is informal seed money, the money available from the people close to the founders, used widely when raising the initial capital to bootstrap the company. Second, the informal venture capital market will be inspected in the light of both research literature and contemporary documentation, revealing the multi-faceted nature of this sector. Third, the formal venture capital industry and its practices will be analysed. Finally, the effect of corporate venturing and especially corporate venture capital on growth business finance will be assessed.

### 2.2.1 Informal Seed Money

The initial seed money collected to fund a nascent company is known by many names: Friendly or friendship money, referring to the nature of the investors; Love money, as the investment is done by those who apparently love either the founder or the idea and judge their investment decision by this; and Blood Money, as the investors are usually blood relatives of the founder or founders. These initial funders are also sometimes called the Three F's, which refer either to *founders, families and friends* (Van Osnabrugge and Robinson 2000, Douglas and Shepherd 2002, Freear et al. 2002), or as in a more prosaic interpretation to *families, friends and fools* (De Noble 2001). One source combines these to 4Fs, consisting of *founders, family, friends and foolhardy investors* (Bygrave et al. 2003). In this study we call it *informal seed money* for obvious reasons: it is gathered from informal sources and used as seed money to start a new company.

Despite its vague position in the literature and research, informal seed money is crucial in starting up new companies. These people put money into deals because they are enamored and supportive of the entrepreneur at a time when other sources of finance are not yet viable (Van Osnabrugge and Robinson 2000). Entrepreneurs reported that receiving 18% of the votes the "three F's" was the second important primary funding source, being roughly ten times more popular than formal venture capital, which in most cases was out of their reach at that point. Still, business angels with their deeper pockets and perceived other added value were the target for 60% of the entrepreneurs. (Benjamin and Margulis 2000)

The drawback of this informal seed money of a friendly nature is its availability and size. The size of initial funding and the availability of further financing is important to the fledgling company. In a growth company the existing funding is easily exhausted before further funding is secured, often resulting in desperate focusing on other work than business development - raising capital or short-term subcontracting - or an outright collapse.

Raising capital may be more or less cumbersome, depending the wealth of the relatives, friends and general. The growing number of wealthy individuals helps, as they may be willing to put some money into risky new ventures even though they could not yet be depicted as business angels. The limit between the informal seed money put in as friendly money and informal venture capital provided by business angels is an interesting question, however. They are both parts of the informal venture capital market, even though in many cases the provider of informal seed money does not get an equity stake in the new venture but merely makes a loan without collateral.

Therefore, the risk is there for all the informal seed money actors. But the difference between informal seed money and informal venture capital is not always clear. The investment of an individual – a friend - buying a ten-percent stake in a venture his former colleague is founding is informal seed money, while a similar investment by a so-called micro-angel in a company of someone his friend knows is informal venture capital. Furthermore, one may wonder about the terminology: A wealthy individual making a convertible loan to an unknown company with no other personal involvement is called a business angel, while the mother-in-law taking out a second mortgage on her house to keep the company of her son-in-law afloat is not. According to Wetzel (1983), business angels do not include founders, friends or relatives, but this may mean that the old categorization within informal venture capital needs to be reviewed.

Perhaps one differentiating factor between these actors is the level of analysis and professionalism attached to their actions. While a full-time VC makes due diligence before investing in a venture, those investing friendly money do it more for personal reasons, as they know the people involved in the project. Investing is definitely not their profession and the due diligence is haphazard or non-existent. Business angels fall in between: they do not generally invest as their professions but still do it for profit, expecting a return on their investment. Therefore, they also analyze the investment more that those informal investors who make investments for personal reasons.

Albeit the research on friendly money investment is scarce, but it can be concluded from the above that it is a significant source of financing for emerging new companies, underrated both in research and in practice. Many of the investments regarded as friendly money investments factually fall into the business angel category, when it is understood broadly. In any case the 3 F’s should be regarded as a substantial part of the informal venture capital market operating in early stage equity financing.

### 2.2.2 Informal Venture Capital

The actors on the informal venture capital market are individuals called business angels. Originally *Angel* was a Broadway term for the well-heeled backers of Broadway shows who made risky investments by producing shows. Attitude, preparation and luck were as important as the quality of the show itself, when raising this capital, and those who put up the money did it also for the privilege of rubbing shoulders with the theater personalities they admired. (Amis and Stevenson 2001) In a current venture capital glossary angel is defined as “A person or entity that provides financing to companies that have progressed beyond the start-up phase but are not yet ready for venture financing” (European…, 2000).

Benjamin and Margulis (2000) have used the depictive term *nonpoor* for business angels, but a more generic term to use might be *Informal Investor*, as done by Erikson and Sørheim (2002). The term *Private Investor* comes suspiciously close to *Private Equity*, which refers to another kind of investing which is quite different from angel investing. To put this in perspective we can quote John L. Rice III, founder of Clayton, Dubilier & Rice, who notes that their minimum private equity investment limit is $250 million to help their portfolio to keep focused on fewer companies (The Private… 2003). In other words, private equity is professional and organized business, as can be seen in the fact that the European Venture Capital Association now calls itself the European Private Equity and Venture Capital Association, even though the acronym EVCA persists.

By and large, business angels are wealthy individuals putting some of their hard-earned capital, business-experience, and contact networks back into the entrepreneurial process. They finance technology-based inventors, provide start-up and early stage financing for emerging firms and equity financing for small established firms growing faster than retained earnings can support (Wetzel 1983). Business angels are profit-driven, market-educated players vested with an extensive value-adding potential. However, they are, in a sense, also hobbyists, in contrast to fairly well-organized venture capitalists. For the majority of business angels this is neither a profession nor a full-time job, and even if it is one’s main job - post-retirement - it does not necessarily fill the hours of the day. Still, there are also business angels who invest professionally.

This controversy is epitomized on the front cover of a hands-on guide for angels, saying that angel investors seek to finance new companies in return for financial returns and personal enjoyment, while inside the same volume the importance of professional approach for success of one's investment activities is emphasized (Amis and Stevenson 2001). One solution to this is to distinguish between micro-angels and business angels, defining the former to cover non-professional investments by ordinary private citizens in ventures founded by other people, while the latter – in fact substantially smaller group - would consist of professional equity investments in new companies (Maula et al. 2003). This group of micro-angels could also include a fair number of actors from the 3 F actors, as noted in the previous chapter.

**Volume and Impact of Business Angel Investing**

Be they hobbyists or professionals, business angels are an important force in economic development and growth of new companies. In addition to being an enabling force for many aspiring entrepreneurs, business angels are also of crucial importance to economies in general. As noted by Van Osnabrugge and Robinson (2000): "The vast size and power of business angel market in the United States is not well understood but is of incredible importance to our entrepreneurial sector and, indirectly, to maintaining our economic growth and standard of living".

Although not tracked by economists, the amount of informal venture capital vs. institutional venture capital has been estimated in many studies. In the UK, informal VC was found to broadly correspond to the amount of institutional venture capital for start-up and early stage ventures (Mason and Harrison 2000b). The overall angel investment market is huge by any standards with more than 700,000 transactions totaling to $56 billion per year. They are also important from the venture's perspective. In a survey done in 1994 on 480 entrepreneurial ventures seeking capital, private placement was the primary targeted founding source for three fifths of the respondents. "Other sources", including venture capital, only accounted for 2% while the "three F's" – founder, family and friends – was the second important, being primary target for 18% of the respondents. (Benjamin and Margulis 2000)

According to International Capital Resources, there are 100 to 140 thousand high-net-worth, high-risk private investors in the US making decisions alone. Forbes estimates the number of US angels to be twice as many, 300,000, but an important thing to remember is that in suitable conditions, many times more individuals and households could become private investors. (Benjamin and Margulis 2000) This "propensity to invest" can be seen in the recent notion that there are about 400,000 active angel investors in the United States that are willing to invest between 25 and 100 thousand dollars in several early stage deals (Sohl 2003), or in the notion that if only half of the dormant *Virgin Angels* became active, the total informal venture capital market on the UK would grow to equal ten times the size of formal venture capital market (Mason and Harrison 1995).

A commonly quoted academic source combines these figures by estimating that in the US there are about 400,000 active angels, investing between $30 billion and $40 billion per year in approximately 50,000 ventures (Sohl 1999). Compared to the venture capital market it is estimated that the volume of angel investing is 30 to 40 times higher (Van Osnabrugge and Robinson 2000). An apparent reason for uncertainty about the number of angels and the extent of their investment activities is the difficulty of reaching business angels: they tend to avoid publicity and stay invisible to avoid the multitude of unqualified investment proposals (Business Angels International 2003) and consist of individuals who do not like to be identified or regulated in any way (Harding 2002). In fact, Wetzel (1983) has suggested that the total population of informal investors is unknown and probably unknowable, and concluding from all of the above we could not agree more. This lack of exposure and visibility in the market also affects the entrepreneurs seeking capital, as it is hard for them to identify and reach the business angels, calling for matching mechanisms such as business angel networks. These will be discussed in a later chapter.

Another factor complicating the effort to draw a picture of a typical business angel is their heterogeneity. An interesting comparison between angel investors in six countries was made by Pereiro (2001), who analyzed factors such as previous entrepreneurial experience, number of investments and source of deal flow. Classifications for business angels and informal investors have been made by many authors, dividing them into two to ten categories depending on the author (see e.g. Gaston 1989, Freear et al. 1994, Stevenson and Coveney 1994, Kelly and Hay 1996, Coveney and Moore 1997, Benjamin and Margulis 2000, Sørheim and Landström 2001).

The distinguishing factors in these business angel taxonomies vary, as they could be the investment activity of the investor (dormant vs. active), participation (passive vs. participating), source and amount of funds (high net worth vs. wage-earning) and so on. Angels also differ in their public image and organization; some get together with colleagues and form private investment companies, others can be regarded as celebrities to a certain extent while another group lies low and operates from behind the scenes (Säntti 2002). This illustrates well the heterogeneity of the group known collectively as business angels and hence implicitly suggests a need to redefine the term. In fact, Sørheim and Landström (2001) created a taxonomy of four different classes of informal investors; *Lotto Investors; Traders; Analytical Investors;* and *Business Angels*. This together with the fact that e.g. the terms informal investor and business angel constantly overlap or are confused in the literature illustrate the fact that the old term – business angel – no longer fulfills its meaning as the generic informal investor.

To start with, the term was not designed for this use but is of a coincidental origin and later adapted to this new use as business angel. Second, as found in the studies on private investors mentioned above, not all of them want to be angels in the sense that they would like to “rub shoulders” with the entrepreneur, or anyone else for that matter. Quite simply, many of them just want to diversify their investment portfolio and invest merely to gain returns on their investment. They get no extra kicks out of working with high-risk ventures and may prefer to stay with local low-growth companies aiming for subtle growth with decent dividends. And conversely, many of the people now referred to as business angels have nothing angelic about them, and may have little to offer in business expertise and time to the companies they invest in, not that they necessarily always should bring expertise to the pool in the first place.

Nevertheless, it has to be acknowledged that the business angels are a fairly well researched phenomenon. For practitioners, there are numerous handbooks to educate both prospective and seasoned angels on informal investment by e.g. Amis and Stevenson (2001), Benjamin and Margulis (2000) and a more scholarly volume by Van Osnabrugge and Robinson (2000). All of these are also beneficial reading for entrepreneurs seeking finance from informal investors, and there are also books especially written for entrepreneurs about business angels (see e.g. Coveney and Moore 1998). On the scientific side, we can draw together certain characteristics of business angels as follows.

**Anatomy of a Business Angel**

Business angels are private individuals. They are not dependent on any market 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 experienced and motivated long-term developers of the company, we have to point out that they lack a certain dynamism.

When selecting their investments, business angels have very differing approaches. While some authors state that the angels mostly invest for non-economic reasons (Baty and Sommer 2002), they still want to have returns on their investment. To assist in this, as well as in finding the investment opportunities in general, they take part in various events and gather in business angel clubs and networks, as will be discussed in the next chapter. By so doing, they can share the insights of several colleagues before decision, and in the case of syndicating the investments among a group they can also spread the risk. Some angels would even be willing to use an independent outside broker in the due diligence process (Freear et al. 1996).

Indeed, perceived low quality of investments is one of the reasons keeping business angels from investing more (Coveney and Moore 1997). Other external barriers to investing include the businesses seeking finance not being ready for investment or "investment-ready" (see Chapter 3.3.1) and the failure of the investor and entrepreneur to find acceptable terms and conditions for the investment. There are also internal barriers because of the often narrow and idiosyncratic investment preferences of business angels. (Mason and Harrison 2001b)

Since business angels in general are private individuals operating with their own money, it is to be expected that there is a multitude of personal reasons for rejecting investment proposals as well, ranging from "simply not interested in the proposed business" to "wife refused" (Wetzel 1983). It should also be noted that a simple matter such as geographical distance may be an obstacle to the investment; the angel wants to be able to monitor his investment without the excessive costs associated with travel. Hence, the target company should be located somewhere within 100 miles (Business Angels International 2003) or 300 miles (Benjamin and Margulis 2000) from the residence of the investor. Controversially, the case is the opposite with a VC investor committing millions at time, when the minimum size of investment turns out to be the barrier instead of the location.

As for being successful as an angel, a recent handbook for present and prospective angel investors lists seven fundamental issues which the winning investors do well: 1) sourcing; 2) evaluating; 3) valuing; 4) structuring (the deal); 5) negotiating; 6) supporting; and 7) harvesting (Amis and Stevenson 2001). This list also serves as a guideline for the process of business angel investment, and apart from the fund-raising it is very similar to the VC investment process as well. At a second glance, one notices that if any business angel manages all these seven steps well his work is bound to go well, as very little of his doings fall outside these categories.

Personal chemistry between the angel and entrepreneur is also of great importance for success, as even though angels may not be able to define what "good chemistry" means they say it is something that "one can feel" at once (Svendsen 2002). For this reason it is understandable that ideally the entrepreneurs should be known to the angel or a trusted associate (Prowse 1998). And after all, it is not the companies which are funded but the people (Benjamin and Margulis 2000).

When compared with their counterparts the venture capitalists, we note that - like VC's - certain business angels consider the personality of the venture founder to be of crucial importance in addition to fun, satisfaction and financial return (Coveney and Moore 1997) and like VC's the business angels do not favor investing in lifestyle companies. As the income for the angel is realized in the exit by either trade sale or public listing, angels look for companies aiming for high growth and globalisation. (Lehtinen 2002) Still, there are also cases of long-term business angel investments for steady companies just for operational profits.

As business angels are most active in early stage investments, it is reasonable to assume that they would act as a feeding line for venture capitalists, funding companies which would eventually be invested in by venture capitalists. It is not that simple, though, and venture capital follows only 10 per cent of angel-invested companies. As Arthur Rock has stated, “VCs are more concerned with creating wealth than creating companies”. (Benjamin and Margulis 2000) Still, it is obvious that co-operation between these two major forces exists and four complementarities have been identified: co-investing in deals; sequential investing in ventures; business angels investing in venture capital funds; and deal referring (Harrison and Mason 2000).

One factor in this co-operation concerns the exit of the business angel. In a sample of angel investments in Finland, the second common exit route in successful exits after trade sale was sale to a third party (Lumme et al. 1996). The same issue was also studied by Mason and Harrison (2002b), who found out that while trade sale was the most common exit route, providing good returns when successful, sales to other shareholders or new third party investors have been predominantly used by investors to exit from poor and moderately performing — or ‘living dead’ — investments. Exit by IPO was relatively rare case reserved for the best-performing investments.

Exiting by selling the shares to new investors is different from taking them in as investors, although the investor may sometimes provide a partial or full exit path to the business angel. The new investor may be a venture capitalist (see e.g. Svendsen 2002), although in general VCs seem reluctant to let any part of the sum invested to pass the company and end up to a third party such as the angel. Still, the exit of the BA at this point sometimes makes sense for all parties. First of all, the relatively early exit returns the capital to the business angel, who can then recycle the funds to another investment without being tied to an overtly long investment span. Second, getting the angel out lessens the risk of conflict later on. Finally, the transaction also simplifies the ownership structure resulting in easier management for the entrepreneur, even though he may have lost the expertise the angel contributed.

**Business Angels from the Entrepreneur Point-of View**

Like formal venture capital, informal venture capital is also supposed to be accompanied by a certain amount of expertise and advice to come along with the monetary resources. The amount and ratio of capital and skills received and needed differs from case to case, as some companies are fairly control-averse while others are especially looking for assistance (Paassilta 1997). An extreme example of this is provided by Christine Kaine, who manages a business angel network in Australia: “In some cases, the entrepreneurs do not really need capital as they are doing all right on that front. Instead they are looking for a partner to come on board with his skills, experience and contacts” (Abernethy 1995).

In the other end are the control-averse entrepreneurs, who do not want to have outsiders in their company to tell them what to do. This of course inhibits their chances for receiving equity investment, as both informal and formal venture capitalists in most cases want to have a certain amount of control in the company – or at least be able to monitor it reliably. The suspiciousness of entrepreneurs is not completely without reason, though, and for historical reasons venture capitalists are sometimes referred to as V*ulture Capitalists* in entrepreneur parlance. Furthermore, there are also angels who specifically want to take over and turn around businesses in distress, to the extent that they are known as *T&T Artists* (Visser and Williams 2001). Both of these terms are suspiciously far from angels.

Let us evaluate the entrepreneur’s perspective on business angels further. First and foremost, the entrepreneur should be aware that informal investors are heterogeneous. Investors have different kinds of qualities and entrepreneurs and co-founders should have a vision of what kind of an investor they need in the founding team (Erikson and Sørheim 2002) as they may have many different kinds of expectations regarding skills, motivation and wealth of the business angel (Paassilta 1997).

For the entrepreneurs raising money from angel investors, two very different approaches can be identified. The first approach is to view capital as a scarce resource, seeing the challenge to be in finding the capital itself, whereas the other groups of entrepreneurs see capital as a commodity. In their view, it is not securing the capital itself that makes the capital acquisition process so difficult, but rather finding investors with the required expertise and contacts. (Sætre 2003)

And once the investor is identified and a meeting agreed, the battle is far from being won. Mike Downey, managing director of Cavendish Management Resources explains that “most private investors have a very short attention span” and suggest presenting a very well explicated “RTI”, abbreviated from Reason To Invest: Why should anybody get excited about this business? He continues with a notion fairly similar to those made on venture capitalists: “Private investors have a two-stage brain. The first stage of the need to get excited about the business and that needs to be communicated in the first few seconds of reading the plan. One excitement has been planted in the investor’s mind, he will then spend the rest of his time looking for reasons why he shouldn’t put money into the company.” (Lindsay 2001) In this persuasive process the personality and psychological attitude of the entrepreneur presenting the case may compensate for lack of potential in some other respects, as the “right” entrepreneur might be able to develop the venture in cooperation with a competent and experienced investor (Svendsen 2002).

At the time of writing, the market situation for business angels is ambivalent for reasons which also affect the formal venture capital industry. The IPO market is cold if not frozen and trade sales rare, diminishing the exit possibilities and the chances for recycling the capital. Further financing rounds are harder to organize and the investment atmosphere is by and large grim. On the other hand, valuations of target companies are much lower than a few years ago, and there is much more time for due diligence and negotiations. In general, the candidate companies and their expectations are much more realistic and competition over them lesser. (Severiens 2002) Furthermore, the relentless flow of negative news led traditional venture capital to practically abandon the early stage investment space, paradoxically creating opportunities for astute angel investors (Jensen 2002).

After all, as noted above this expertise and added value is supposed to be an integral part of the angel investment, analogous to the VC investment. Interestingly, when angels with successful exits were compared to a group with recent unsuccessful exits, the latter group showed higher average assessment of the value of their contribution to the company. This may be interpreted by noting that unsuccessful investors have an inflated opinion of the value of their hand-on contribution, whereas the successful investors recognize that the entrepreneur is in the driving seat and hence the investor’s influence is relatively marginal to the success of the company. (Lumme et al. 1996) We might also reflect that successful investors consider themselves as contributors of finance, not knowledge, although the same study noted that both groups used equal amount of time with the company.

**Summary**

The above review of the business angel phenomenon and informal venture capital in general merely scratches the surface of this complex subject. On the other hand, despite the extensive research on the subject, the area is largely unknown and many questions remain unanswered: What are the angels’real expectations on returns? Why are more of the potential investors not becoming active?

How much deal flow do they wish or need, and where does it come from? Reliable answers to these questions will assist practitioners as well as policy makers in creating more a functional informal investment market. (Freear et al. 2002)

We can conclude that business angels operating informally are a very important factor in the early-stage financing of risk-intensive ventures. Problems originating from visibility and reach as well as added value have been identified, and finding solutions to them would result in more efficient financing market and growth venturing environment. It should be noted, though, that the group quoted as business angels is by nature diversified and hence very heterogeneous. Not all of them are willing or even able to contribute more than money to the venture. The majority of informal venture capital actors make investments on a non-professional basis as opposed to business angel activity, sometimes defined as professional investments made by private individuals. None of these problems are fatal, though, and they can even be converted to opportunities: Building matching services would result in better efficiency, and diversity of investors is needed by the wide range of ventures seeking financing.

### 2.2.3 Formal Venture Capital

Origin and Development of Venture Capital

Originally, venture capital referred to financing provided for new higher risk ventures such as start-up companies. Over time, the term has expanded to include investment in management buy-outs and other situations in which venture capitalists invested. Venture capital investments are generally characterized by high risk and an expectation of high return. Venture capitalists, in turn, are those individuals and entities that specialize in providing venture capital financing. (Europea… 2000)

Most venture capital funds today follow the form illustrated in the figure below: Investors put money into a fund, from which venture capitalists make cash investments to investee firms, receiving equity in return. Eventually, these investments are exited either negatively by write-offs caused by liquidations or positively through trade sales and public listings, and most of the returns forwarded to the original investors of the fund.

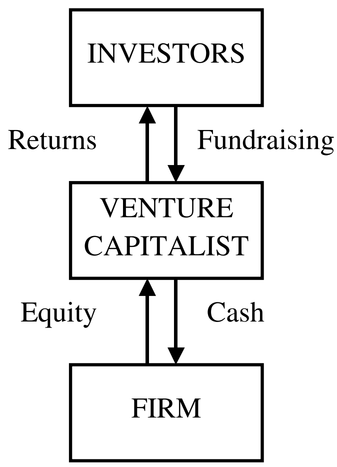


Figure 6: An overview of the Venture Capital Process (Gompers and Lerner 1999)

The first formal venture capital company is usually regarded to be American Research and Development, even though J. H Whitney & Co. was founded earlier the same year, in 1946. Their leaders - General Georges Doriot and Jock Whitney - and eventual successes with e.g. DEC and Minute Maid, respectively, have become industry folklore as something which started a new era and industry. Both of these companies made investments from their own balance sheet, thus representing the one-company or development company model (Seppä 2000).

The next milestone in the history of venture capital was the emergence of the venture capital limited partnership - namely Draper, Gaither and Anderson in 1958 - separating the funds from the managers (Gompers and Lerner 1999). It made the partnership an agent to whom the funders as principals gave the responsibility of investing and monitoring the funds given under their management. This model eventually became the de facto operating model of the industry: the vast majority of today's VC partnerships have one or several funds under their management. (Seppä 2000)

Their income is basically formed by annual fees as percentages of the fund under management plus a share of the hoped-for profits after the fund has matured. The average management fee in the US has been 2.5 percent with carried interest of 20 percent of this, possibly with some hurdle rates. In practice the latter means that the fund managers get 20 percent of the returns above a set base of e.g. ten percent. (Singer 1994, Blake 1994) The VC managers typically engage in board work in the investee companies, and in many cases the actual investors have a say in decisions as they have formed an investment council to have some degree of control over investments, thus in a sense limiting the freedom of the fund managers.

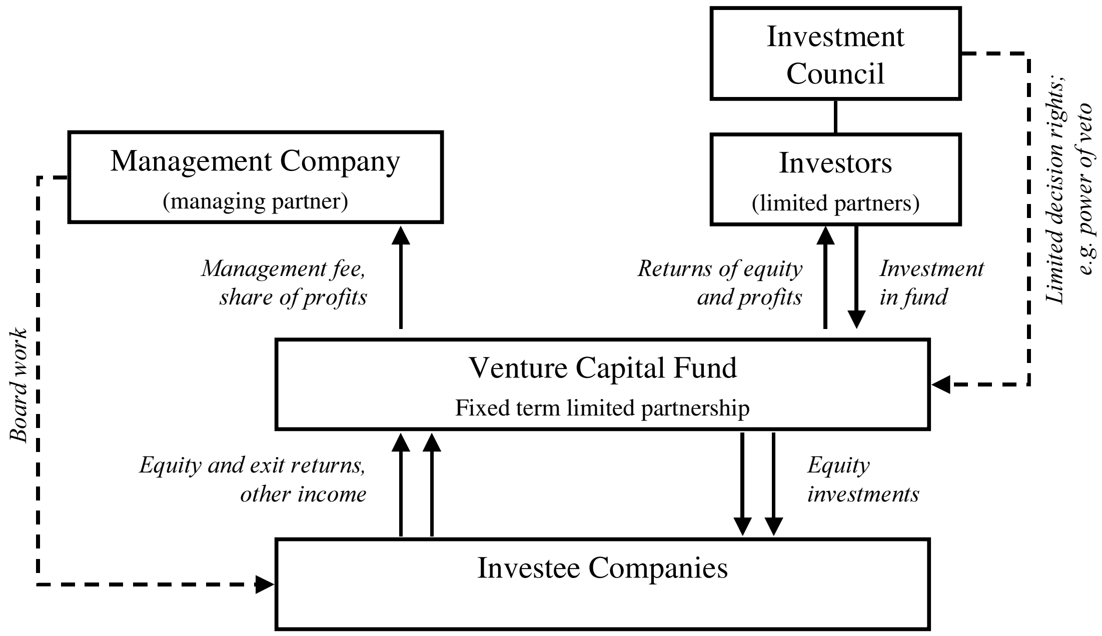


Figure 7: Limited Partnership Venture Capital Fund Model (FVCA 2003b)

This more elaborate model is illustrated in Figure 7. In this illustration the management company could also reside between the fund and investee company, which might depict the position of the parties better. It is the people working for the management partnership who are in interaction with the venture, managing the fund in practice. Principally the fund is represented by the investment council appointed by the investors, but they interact only with the managers, monitoring and in some cases approving their decisions. Therefore, the fund is a faceless entity as far as the entrepreneur is concerned.

**Venture Capital Spiral and Other Recent Developments**

Over time, the Venture Capital Funds grew bigger as they gained popularity among investors. Relieved investment policies of insurance companies and pension funds drew them to direct a percentage of their funds to unlisted companies through VC funds, soon making them the biggest funders (see e.g. EVCA 2002a, FVCA 2003a, Arundale 2003) and accounting for much of the overall growth in fund sizes and total amount of VC funds. This, in turn, pushed VC's to make bigger investments, the adverse effect of which is clarified by the venture capital spiral.

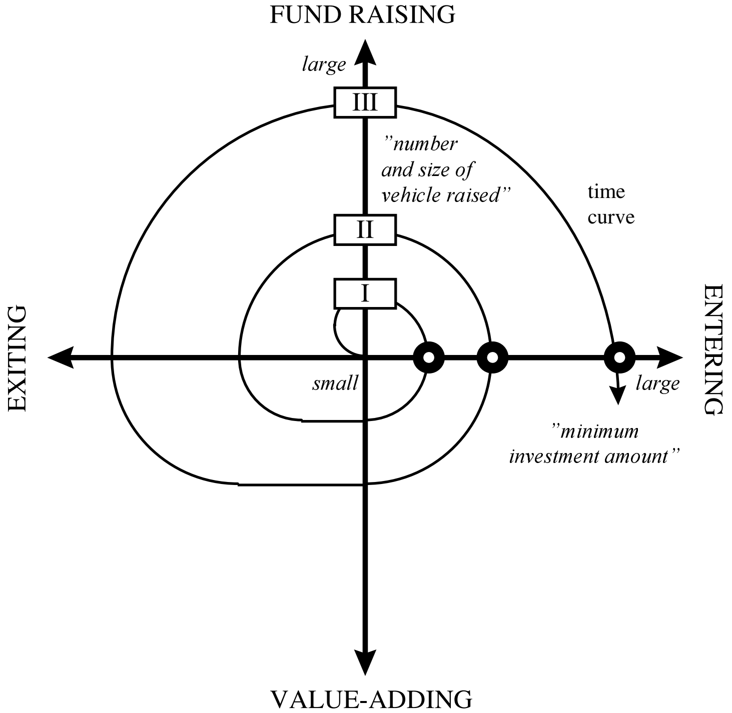


Figure 8: The Venture Capital Spiral (Seppä 2000)

The figure above depicts the venture capital cycle in four steps, the standard typology of today: Fund raising, entering, value-adding and exiting. The venture capital spiral illustrates how the first fund is raised, followed by entering, i.e. making investments in target companies. After this, the intention of any VC is to provide added value to the company, so that the exit would be as lucrative as possible. A good exit means prosperity for all parties; entrepreneur, venture capitalist and fund investor.

The system proved to provide good returns to the investors, apart from the occasional bad years, and the upside potential was also tempting. Therefore, as the funds were returned to the investors they – and others - were ready to invest more to put together a new, bigger fund. "Bigger funds, bigger returns" was the apparent reasoning. The end result was institutionalisation of venture capital, as illustrated by the venture capital spiral. (Seppä 2000)

Naturally, venture capital companies hired more people to handle the increased amount of investments, but the average size of investment also rose due to several reasons. First, there was added competition among VC's for good investment targets, raising their valuations. Second, competitive environment among high-tech start-ups required them to develop fast, adding to the need for capital to be burned. And from the VC point-of-view, larger investment means better cost-efficiency: with larger investments one manager can handle a bigger amount of funds managed by the VC company, resulting in a higher amount of commissions. After all, in a sense the business of any VC company is buying and selling money.

“Luckily” for the Venture Capital companies, in the late 90’s the Internet boom was ongoing, providing demand for the rising amount of funds. The VC booms come and go, and with them the IPO market. This had been proven a decade or two earlier with hard drives, which were introduced to the market in 1973 and were the “darling industry” of all venture capitalists between 1977 and 1984, causing them to invest in far too many start-ups in just one industry to create a healthy market (Bygrave and Timmons 1992). This phenomenon is referred to as Capital Market Myopia (Sahlman and Stevenson 1985); as soon as someone seems to have a company with a successful idea, others will follow unanimously on “me-too” basis, as the practitioners call it.

In a while, the dot-com boom was on and there was no shortage of inspired entrepreneur-resembling-creatures with red-hot seed-stage business ideas, in need of capital injection before they would go public. A lively real-world example of this is given by Valtonen (2001) in his autobiographical book depicting the rise and fall of Wap-It, a mobile internet start-up in which he was involved. At a certain moment they needed but “hint publicly that Wap-It could take some more money in to finish the products and the next thing we needed to do was to help the financiers form a line at the door”.

Furthermore, the amounts even the most inexperienced VC’s and the youngest entrepreneurs were nonchalantly speaking of were so big, that “it was unbelievable to someone who was coming from another trade” (ibid.). In practice, the entrepreneurs were compelled to speak in high figures to attain credibility. The most experienced and prominent VC companies also fell to the temptation and forcing entrepreneurs to grow at artificially accelerated speed drove many of their target companies into bankruptcy, sometimes losing tens of millions of dollars in a single case (Stein 2002, compare also with case Idealab in Chapter 4.2.14).

In retrospect, the situation resembles the well-known story about the Emperor’s New Clothes by Andersen (1969) or a less known curious practice of Kwakiutl (a.k.a. Kwagul) Indians who lived in the upper west coast of North America. They made copper statuettes, which had absolutely no practical use but instead were used as artefacts in rituals and traded for slaves. The statuettes were also proof of wealth and as such were sometimes offered for sale to competitors, especially in other tribes. If the other party could or would not pay the exorbitant “I-dare-you-pay” price, the person and therefore the whole tribe was declared to be poor and their name disgraced (Ihalainen 1996).

Unfortunately, venture capital is not scalable. There is a limit in the availability of good investment targets as well as skillful fund managers, the venture capitalists themselves. Competing for targets makes the valuations go up, resulting in lower returns for the investors. Many of the business ideas of the late nineties would not have received funding had it not been an overheated market, and some of the companies were designed outright to exploit the situation. In the latter case, a business plan would be engineered to give the right answers and thus fulfil the investors’ needs artificially. In some cases, though, these companies went public and provided investors with good returns. But despite their skill and agility, the founders do not necessarily do honour to the term entrepreneur.

Also, training venture capitalists to be able to really add value to the start-up companies is not simple and straightforward; the skills are not similar to those of an investment banker or a mere business consultant as will be noted in chapter 3.2.2 where competence gap is discussed. Even though there is training available for venture capitalists by organizations such as the National Venture Capital Association (NVCA) or the Venture Capital Institute (VCI), there are many things in the trade which are not taught in classrooms. Thus they have to be either learned by doing or by having more experienced colleagues as mentors (Taylor 2002). At any rate, from the notion of venture capitalists having less time and experience to offer for each target company, we could claim that in a relative sense the amount of added value comes down as funds sizes go up.

All in all, the success of the VC market increases the size of funds, pushing the minimum investment up as illustrated by the venture capital spiral. And in addition to the two other contributing factors, added competition among both venture capitalists for targets and among investee companies for markets, there is one more factor pushing minimum investment size upwards: lowered returns, compelling venture capital companies towards cost-efficiency.

In the experience of the author, in 2000 it was harder to get investment for a company with a ready tangible product with a steady growth path than for a hypothetical online business model with no profit model defined. Also, to yield better results and even to catch investors' attention at all, one was to ask for five million Euro instead of one. The spirit of those days was depicted in August 1999 by a comment from the Herring on Hollywood conference panel attended by the author: "Damn the profits, its eyeballs that count".

**Current Status of Venture Capital**

When the internet bubble bursted, the market went haywire for a while, but has now stabilized into a fairly normal state, even though the IPO market is still low. Still, the grey cloud may have a silver lining for both entrepreneurs and investors. In late 2002 it was estimated that there was $90 billion of committed capital waiting to be invested, forming an unforeseen "overhang" as it is known in VC parlance. This was enough to jumpstart a host of new companies. Furthermore, those VC's with money to invest enjoy a buyer's market with more realistic valuations compared to the highest bidder rage of the late 90's, and ventures with solid business proposals are again appreciated. (Grimes 2002)

Not all of this capital is available for new investments, though, as many of those companies which got investment during the boom are now struggling for survival and hoping to get additional capital to get over the worst. But having invested and lost $15.3 billion after 1999, which vanished before 2002 ended, the VC's are not that keen on risking more money in their portfolio companies (ibid.). And even if they do, the conditions are much harder for the entrepreneur and possible other existing investors. The overhang itself also causes problems for VC's. Especially in the US and also in many other nations many venture capital partnerships have been closed down and some funds have either had to return all or part of the funds to investors or lower their exorbitant management fees agreed during the overheated phase of the market.

Yet another fact contributing to the demise of venture capital is the more or less dead IPO market, inhibiting the venture capital cycle from operating properly. Since venture capital has to plan or at least think about the exit before making the investment, as long as the exit market does not function as it is supposed to the whole private equity investment market is crippled. The effect of this is reflected all the way down to seed funding. (Hyytinen and Pajarinen 2003) But by and large, the surviving funds and partnerships are larger than ever, and the equity gap persists: later stage investments are preferred over seed and early-stage investments.

Coming back to basics, the effect of venture capital on entrepreneurship is two-fold, as it can be seen as both promoting and destroying it in its own way. The profit expectations attached to VC investment often dictate that the company will be sold and become part of a bigger one. This may lead to he death of entrepreneurship, and many family companies with good prospects have vanished this way. Yet, it should be acknowledged that through the acquisition the entrepreneurs have received a reward for their risk-taking and work. Nevertheless, one of the reasons for this development may be the dominating nature of venture capital; other financing instruments are not developed as actively as they are not seen to be important when VC is supposed to cater all needs. (Moisander 2003)

Among policy makers, venture capital has been considered for a long time to be an important means of providing capital for early-stage ventures and hence facilitating entrepreneurship, innovation, employment and general economic growth (Harding 2002). Therefore, many countries formulated policies which enabled and promoted such business activity, and to be on the safe side started public venture capital companies to open the market for private companies. In general, this worked well and venture capital has expanded from a curiosity in financial business to a major and influential industry.

Currently, the majority of private equity flows into later stage investments (see e.g. Singer 1994, EVCA 2002a, FVCA 2003a, Arundale 2003), which provide a less risky environment and larger investment sizes, which is welcome to the VC's and their investors. Furthermore, those later stage investments need less involvement and special skills from the VC, as the management in MBO and LBO deals has already been working in the company for years, and the transaction is close to investment banking. Thus, entrepreneurial skills essential for grooming start-up companies are no longer needed for the later-stage venture capitalists.

It is no wonder the later-stage investment market seems more attractive to the VC investors, who are responsible to their investors not only for investing all the funds designated to be invested, but also getting the funds back with profit. But is later-stage investing still "venture capital" activity in its original form, or should it be referred to as "merchant capital"? One indication of this difference is that the European Venture Capital Association started calling itself the European Private Equity and Venture Capital Association in the late 1990's. In later-stage investments, the risk is relatively low and anticipated timing is likely, which appears to be close to investment banking and undeniably has certain attractive qualities.

Still, there are also those who swim against the tide, setting up management partnerships and raising funds when others are closing down. An example of this is the Mentor Fund established in Canada in early 2003 to cater for the marketing communications industry. What also makes them a potential messenger of a new era is that they explicitly declare that their partners are experts in differing fields – currently CFO, business development, investment banking and human resources - and look forward to being able to assist their portfolio companies substantially after investment. Hence the name Mentor Fund is in line with the strategy of this particular operative. (Warren 2003)

To conclude this brief analysis of venture capital investing, we can note that now, more than ten years after Bygrave and Timmons wrote their book "Venture Capital in a Crossroads" (1992), the subject is again very topical. In a recent conference in 2002 (www.businessforum.com), Paul A. Gompers proclaimed that venture capitalists are again facing new challenges, and that the VC industry of 2010 will be very different from that operating today. Actors will be more professional as financial service organizations and alternative approaches will develop in the field as there is no single right answer. There are new opportunities, but in the future way more transparency will be expected from the industry. Nevertheless, VC has grown to play a considerable role in the economy, and – as noted by Gompers – even though it will presumably go through some profound changes in structure it will look substantially better at the end of this decade.

For those who strive for a better understanding of the history and development of venture capital, there is ample literature and studies available on the subject. For example, Bygrave and Timmons give a very good overview on the subject in their landmark tome Venture Capital at the Crossroads (Bygrave and Timmons 1992), while contemporary "true stories" can be read in authors such as Gupta (2000) and Quindlen (2000). A good comprehensive look at venture capital within, i.e. as someone's business was made by Seppä (2000), while the VC mechanisms have been observed and described e.g. by Gompers and Lerner (1999). From an entrepreneur's perspective, there are numerous books intended to assist the entrepreneur in understanding venture capital as a phenomenon and in taking advantage of it. Such guides include work by authors like Bartlett (1999), Baird (1999), Gladstone and Gladstone (2002) and Nesheim (2000), among many others.

### 2.2.4 Corporate Venturing

The Role of Corporations in Birth and Development of New Companies

Many corporations take an active role in funding and founding new companies, for which they have many tools gathered under the label Corporate Venturing. An important incentive for this is to offset their reduced capacity to innovate and identify and build on new opportunities (Bridge et al. 1998). The tools fall into two main categories, internal and external venturing. (Keil 2000) Internal venturing basically refers to funding of internal ventures that, while distinct from a company's core business and granted some organizational autonomy, remain legally part of the company. Funding start-ups which have already spun off as independent businesses, however, comes under Corporate Venture Capital. (Chesbrough 2002)

The most explicit form of external venturing is *corporate venture capital* (CVC), referring to the investments of corporate funds in external start-up companies. This can be done either directly by a self-managed fund, or indirectly by having a third party to manage a fund or even making an investment in an external fund. In the strictest definitions only direct investments count as CVC, making it fairly similar to the activities of ordinary venture capitalists but with certain unique features, which will be discussed later in this chapter. Other forms of external venturing include alliances and transformational arrangements, covering various other tools for corporate venturing such as strategic alliances, joint ventures and spin-offs.

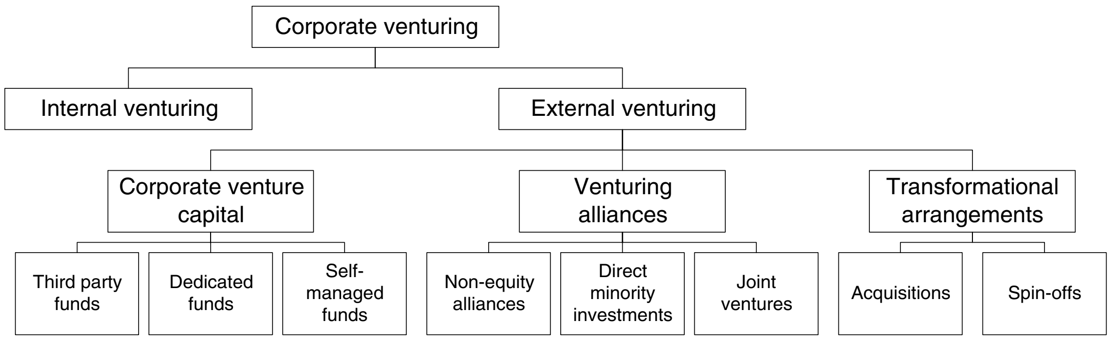


Figure 9: Modes of Internal and External Corporate Venturing (Keil 2000)

It should be noted that although authors generally agree on the nature of entrepreneurial activities within existing firms as described above, differences in terminology and definitions cause confusion (Sharma and Chrisman 1999). Therefore, the categories are not strictly narrowed down in the literature, and it does not help that in practise a spin-off may have elements of e.g. joint venture, strategic alliance and corporate venture capital, causing the categories to overlap. Also, due to the similarity of the terms they are often confused even in professional usage, especially in the case of Corporate Venturing and Corporate Venture Capital (compare e.g. Keil 2000, Chesbrough 2002, Cowley 2002 and EVCA 2003), though the above definitions show their different objectives.

Reflecting this a major European authority in the form of the European Private Equity and Venture Capital Association notes that there is no single definition for Corporate Venturing that seems to satisfy all parties. By their definition, however, the controversy originates from the difference between direct and indirect corporate venturing, where the latter means investments in funds managed by a third party. (EVCA 2003) This, again, is beyond the scope of corporate venturing and even corporate venture capital by another definition (Chesbrough 2002) while it is part of CVC by a third (Keil 2000). One reason for this plurality of definitions may be that for the actors, CVC is “business as usual”.

Multiple Reasons Behind Corporate Venturing

Among the types of corporate venturing activities this study is most interested in Corporate Venture Capital, as it can be considered as an alternative for funding provided by normal venture capital companies. The reasoning as well as the success of different CVC actors varies greatly. When looking at corporate VC investment, one can analyze two distinct factors: *a) its objective* and *b) the degree to which the operations of the investing company are linked together* (Chesbrough 2002).

In many cases, the objective is strategic: they are made to increase the sales and profits of the investor’s own business. Hence, a company making a strategic investment seeks to identify and exploit synergies between itself and a new venture. The alternative investment objective is financial, wherein a company is mainly looking for attractive returns just like any other venture capitalist. Here, the reasoning is that the superior knowledge of markets and technologies gives the corporation a leading edge over the more generalist VC actors. Also, the investor may leverage its own resources, sales channels and brand to the benefit of the investee company. (ibid.)

On a critical note, one may question the alleged advantages of a CVC over traditional VC’s. First of all, VC’s make the investments as their sole business; why would a corporation succeed better in their area of expertise? Secondly, as the corporation may have also other, more subtle or even hidden objectives than plain financial returns, the target company’s ability to attract successive rounds of financing may be hindered by the fact that there is already a corporate VC on board, possibly having an agenda of its own for the future of the company. This might jeopardize e.g. an exit by trade sale if the CVC perceived the buyer as an ‘unfriendly party’.

The second defining characteristic of CVC investments is the degree to which target companies are linked to the investing company’s operational capabilities. For example, the start-up might make use of the investing company’s manufacturing plants, distribution channels, technology and brand, or adopt some of its business practices and processes (Chesbrough 2002). There is a caveat in this,too: proximity of the corporation may block the innovativity of the start-up and harness a spirit which should not be harnessed. In fact, many corporations have noticed their poor performance in exploiting innovations especially in technologies, which are disruptive to their current mainstream products. Therefore, to effectively spin out new companies and divisions, they should be placed clearly apart from the parent organization to avoid its constricting effect (Christensen 1997, Ferrary 2003).

These two dimensions can be combined in a matrix to create a framework for assessing the corporate venture capital investments as done in Figure 10 [4]. Since the depicted separation into strategic versus financial and tightly linked versus loosely linked is purely black-and-white, four distinct types of investments can be identified. *Driving Investments* are made on strategic rationale and kept with close links to the investing company. They are directly connected with the investor's current business and – if successful – will advance the strategy of the corporation. *Enabling Investments* are also of a strategic nature, but the benefit for the investing company will come indirectly by e.g. increased demand for its products used by the clients of the investee company's technology. Optionlike *Emergent Investments* are made in companies with a focus outside the investor's strategy, but in areas which might be strategically important in the future. Passive Investments are closest to the practice of any other venture capital investor subject to the vagaries of the private equity market, and can be argued to be a misuse of shareholder's funds. (Chesbrough 2002)

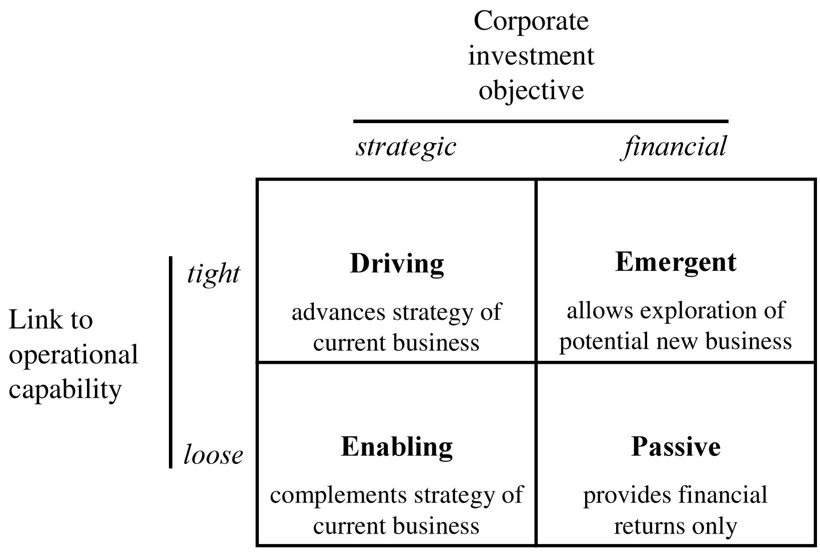


Figure 10: Mapping Corporate Venture Capital Investments (Chesbrough 2002)

As opposed to Corporate VC, Corporate Venturing (CV) includes funding of internal ventures which have a certain degree of autonomy but still are legally part of the company. The distinction between these two is sometimes vague, and some operatives engage in both activities. For instance, the original role of DaimlerChrysler Venture when founded in 1997 was to provide employees with capital and know-how, but after a number of successes the fund was also opened up to external projects in 2000. This kind of development was also boosted by the success of the overall venture capital business during that era. (Cowley 2002) Since then, however, there have been major write offs and venturing and CVC activities have slowed down substantially. (see e.g. Cowley 2002, EVCA 2003) This may partially reflect that CVC is in some cases more an extension of corporate strategy than venture capital activity.

[4] A fairly similar classification is made by Campbell et al. (2003), who divide the CVC investments into Ecosystem Venturing, Innovation Venturing, Harvest Venturing and Private Equity Venturing.

**Present Status of Corporate Venturing**

Despite some setbacks, Corporate VC is very much alive. As an example of this we can look at the diverse activities of Nokia Ventures Organization, which with its 1500 people is the smallest of three Nokia divisions[5]. First of all, there is Nokia Venture Partners (nokiaventurepartners.com), launched in 1998. It is a corporate venture capital unit with $650 million under management and typical investment between $2 to 10 million. Secondly, the New Growth Businesses unit has been developing internal ideas for years to transform them into substantial, sustainable businesses. Recently, its operation was also opened to external companies and innovators, and the typical investment size is said to be less than €300k. An interesting point in these cases is that the preference is not to make an equity investment but to form a co-operation contract with the investee. (Nokia 2003, Pirttijoki 2003)

New Growth Businesses unit also includes the Nokia Early Stage Technology Fund, the acronym of which is aptly NEST. This fund of €40 million was launched in late 2001 and typical investment size is said to be between €1 to 3 million. NEST has made investments in three spin-offs, in which the workers are no longer employees of Nokia and the entrepreneurs involved have to carry the business risks themselves. (Lagus 2002, Nokia 2003) Yet another form of Nokia's venturing activities is the Innovent unit (www.nokia.com/innovent), which offers collaboration for early stage entrepreneurs, helping them build their ideas into businesses and getting them funded.

In the above example we can see that for example Nokia has more or less all bases covered, with venture-oriented activities more or less in all the categories illustrated in Figure 9. Still, it can be seen from the operation model of major CVC actors that a substantial part of what they do is to use the marketplace in a way as their Petri dish. Instead of making all their research in-house, they either cultivate new ideas in external start-ups they finance, internal corporate venturing or incubating, or directly by buying fledgling companies which have an interesting idea or innovation. On the other hand, this also works the other way around. After all, not all the new companies are even intended to end up as viable, independent companies. Instead, they are created to vet ideas and create new technologies, testing out markets and taking risks, and eventually end up into the lap of a larger organization which can fully exploit the potential of the idea (Komisar 2001a).

Despite all the drawbacks presented in the above discussion, there are undeniable opportunities in close cooperation with an industry leader. Jumpstarting the company with sales channels readily available may dramatically shorten the time-to-market, and using the parent's name may open doors which would otherwise stay shut for a long time, until the start-up had itself gained a credible position in the market. In this role, the investing company may have substantial impact on the companies it works with, not only through the push introduced by the invested money but also the pull by the other resources put at the disposal of the target company.

This "Engine Company" effect can often be seen around a strong local technology company, even if it has not got an official corporate VC arm (Sorvisto 2003). Indeed, besides the actual corporate VC money, another significant source of initial capital for early-stage technology-based ventures e.g. in the US has been the strategic partners. In these cases the investor is far larger than the seed-phase investee and the alliance in many cases formed for seed capital investment purposes. (Carayannis et al. 2000)

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[5] As of January 2004, the other two were Nokia Mobile Phones and Nokia Networks concentrating respectively on mobile phones and cellular networks.

In addition to assisting external companies, these capabilities can of course also be used in internal corporate venturing, e.g. in spinning out divisions and companies for disruptive technologies as noted earlier in this chapter. Even a practice called 'Fast Venturing' has been proposed in the literature, which would utilize all the required resources and operational partners and hence be able to move at an unprecedented speed as a start-up, especially a web start-up (Kambil et al. 2000). Even though not all of the ideas affiliated with this high-rolling concept proved to work in the long run, the benefits achievable by a large company or coalition of companies facilitating early steps of a new venture are definitely an under-utilized resource.

**Summary**

The set of research-based recommendations by Maula (2001) for new technology-based firms looking for corporate venture capital summarizes many issues found in this chapter:

1. Select investors as carefully as they select you.
2. Build a portfolio of investors to suit your needs, possibly including several corporate investors.
3. Pay attention to the complementarities between you and the investor, as they are critical for co-operation.
4. Use social interaction to acquire knowledge and to identify opportunities for co-operation.
5. Consider the potential of the investor in resource acquisition, endorsements, learning and internationalization.
6. Do not reveal more technical documentation than necessary.

These recommendations implicitly emphasize that there are two sides in corporate venturing; the investing company and the target company, and that there are many kinds of corporate investors. Differences may be explicit or more subtle, and objectives sometimes even hidden from the investment targets. Nevertheless, a larger company naturally brings many possible advantages to a small company as a partner or investor.

## 2.3 Entrepreneurship

*"With the humblest start and trifling capital, a shrewd and able man will rise to wealth" – Buddha*

This section has its main focus on entrepreneurship, also considering a number of other aspects of the subject. From the entrepreneur's point of view, a venture is needed in commercialization of the innovation. The entrepreneurial process could be compared to that of raising a child. In addition to the parents, assistance is needed from many other people to keep the child healthy, take care of his education and so on. Similarly, the entrepreneur can obtain assistance e.g. from advisors and mentors, who help the company to grow faster and become healthier. If the process is successful, the venture will bring its product to the marketplace and eventually becomes economically profitable.

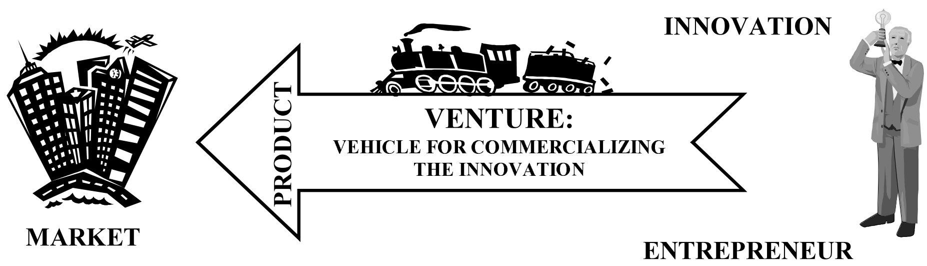


Figure 11: Venture as the entrepreneurial vehicle for commercializing an innovation

The next two chapters discuss the two important ingredients of venturing: entrepreneurs and innovations. After this we will analyze different aspects in ventures, ultimately focusing on growth-oriented companies, which are in the focus of this study. After all, not all new enterprises are intended to be fast-growing high-tech businesses in the first place. The aides which the entrepreneur may need during the early stages of the company development are covered elsewhere in this study; advisors, incubators and mentors, as well as the early stage financiers.

### 2.3.1 Entrepreneur – the Driving Force

*"If the mind be fixed on the acquirement of any object, that object will be attained." – Buddha*

As noted by an authority on the subject, despite the fact that the term entrepreneur has been used for over 200 years, there is total confusion over its definition (Drucker 1994). The earliest reference to the term *entrepreneur* has been traced back to 1734, to Richard Cantillon's work in the field of economics. This is not to say that entrepreneurial activities did not exist before that, merely that the origin of the entrepreneurship is in France in times of the Enlightenment, when feudalism and the guild system were falling in the wake of industrialization (Kyrö 1998). Originally, the concept of entrepreneurship meant self-employment with known costs and uncertain returns, and the focus was on the entrepreneur as a person.

The word itself was derived from the French word *entreprendre* - meaning "to undertake" – Cantillon was Irish and lived in France. (Lambing and Kuehl 1997, Bridge et al. 1998) He considered the entrepreneur to be the bridge between those in possession of capital and the opportunities they wanted to pursue in person; it was left to the entrepreneur to bear the risk. Later in that century the concept of entrepreneurship was expanded to include planning, supervising, organizing and even owning the factors of production. In 1803, Jean Baptiste Say finally proposed that the profits of entrepreneurship were distinct and separate from the profits arising from the ownership of capital. (Coulter 2001)

Apart from this gradual development hinting towards the division between venture capitalist and entrepreneur of today, the research of the first two hundred years concentrated on the personality of the entrepreneur, trying to find the set of entrepreneurial traits individuals were either born with or not. Today, the focus is wider, and several definitions – and even contexts - exist for entrepreneur and entrepreneurship. As early as in 1934, Schumpeter defined entrepreneur as "a person who carries out new combinations, which may take the form of new products, processes, markets, organizational form or sources of supply" (Lambing and Kuehl 1997).

A more recent definition says that an entrepreneur is "an individual who establishes and manages a business for the principal purpose of profit and growth, and is characterized principally by innovative behaviour and will employ strategic management practices in the business" (Carland et al. 1984). Webster's dictionary (1989) defines entrepreneur as "a person who organizes and manages any enterprise, especially in business, usually with considerable initiative and risk".

When trying to find out the reasons for becoming an entrepreneur or characteristics of a typical entrepreneur one finds that there is material in abundance on the subject both in practical and academic fields, written by practitioners, journalists, and scholars of many fields – not to mention entrepreneurs themselves. Indeed, entrepreneurship can be approached both in practice and theoretically from many directions, and studies have been made for instance using economics, sociology, anthropology or management as the framework (Ucbasaran et al. 2001). In order to organize this multitude of disciplines, there have even been efforts to create classifications to sort out these theories, starting from the French tradition and spanning to nine other classes of the entrepreneurial function (Cuevas 1994).

Despite the large body of literature on the subject, it remains to be seen whether it is too ambitious to expect a complete and robust single theory of entrepreneurship due to the interdisciplinary nature of the phenomenon (Amit et al. 1993). But the challenge is real and the field just keeps on expanding: Recent research has recognized that entrepreneurship may not be a single-event action, and that it not only involves the creation of new businesses but also inheritance and purchase of established businesses. Furthermore, different kinds of entrepreneurs have been indentified, such as virgin, habitual and serial entrepreneurs, all possessing and requiring different traits. (Wright and Westhead 1998)

Entrepreneurs themselves have also been studied a lot, and a great number of studies and theories have been presented, trying to answer the questions of who becomes an entrepreneur and why, and what the differentiating factors are which make some of them more successful than others. Traditional viewpoints include trying to define the entrepreneurial traits, so as to find the optimal entrepreneur (see e.g. Chell et al. 1991) or finding out the typical background characteristics of nascent entrepreneurs, i.e. those individuals who are aiming to start an independent business (Delmar and Davidsson 2000), among others.

Studies on entrepreneurial traits can also be classified according to their locus, as was done by Cunningham and Lischeron; to the 'great person school'; the psychological characteristics school; the classical school, the management school; the leadership school; and the intrapreneurship school. Many of these studies, concentrating on the personality, backgrounds, early experiences and traits of the entrepreneurs may be criticized e.g. for trying to explain a multi-faceted phenomenon by a single factor (Ucbasaran et al. 2001). Still, apart from the traits approach, we should note that venture capitalists are intensely interested in behavioral and psychological characteristics of the entrepreneur (Cooper 1993), apparently for a reason. After all, high growth has been found to be associated with "entrepreneurial style management" – managing culture and vision rather than performance itself (Sadler-Smith et al. 2003).

Still, the fact remains that we do not know whether entrepreneurs are made or born or both – and whether this matters at all. Little is known about the entrepreneurial process – the process of becoming an entrepreneur (Brereton and Jones 2002). We can talk about "happenstance versus planning" - in many cases individuals seemingly end up being entrepreneurs by a chain of unplanned events, although these individual often have a certain propensity towards this development somehow reminiscent of the concept of "guided luck" presented on page 62. And still, we can not overrule the whole "traits-based theory", since it is obvious that personality and background affects one's propensity to become an entrepreneur.

There are of course those who plan for entrepreneurship for years, setting up plans in advance as they start working for someone else in a position which might provide for them to seize an opportunity and build their own company. (Vesper 1980) But even if Larry Ellison might have planned for entrepreneurship years before he founded Oracle at the age of 33, we can fairly safely assume that the 19-year-old Michael Dell found an opportunity in 1984 and grabbed it by first starting to sell computers from his apartment, and later expanding this to become one of the leading computer companies in the world (Nordström and Ridderstråle 1999). Yet success is not necessarily planned in advance or it does not come in the anticipated form: Bill Hewlett and David Packard had no specific idea to pursue when Hewlett-Packard was founded, and their business was vaguely defined as electronic engineering. According to Hewlett, they "did anything that would bring in a nickel" – a situation familiar to many start-up venturers. (Collins 1993)

The division between the two broad types of entrepreneurs, *craftsmen* and *opportunists*, was found as early as 1967 by Smith. The craftsmen are typified as coming from a blue-collar background, with limited experience, with a preference for technical work and motivated by personal autonomy. In contrast, opportunist entrepreneurs typically have higher levels of education and experience, with motivation to build a successful organization and achieve financial gains. (Smith 1967)

**Entrepreneurial Capital and Constructive Opportunism**

An interesting viewpoint summarizing the results of several earlier studies, most notably and explicitly the works of Casson, Kirzner, McClelland and Schumpeter, is given by the notion of *Entrepreneurial Capital*, a concept refined through resource-based theory. It is a combined capacity as shown in the figure below. The horizontal axis represents the motivation, intention, goal, staying power and commitment devoted to the project. The vertical axis comes from opportunity recognition and Z dimension from capacity to create new combinations and co-ordinate scarce resources. The framework serves as a useful tool for the analysis of entrepreneurial potential and facilitates the development of tools to enhance an entity's wealth creation capabilities. (Erikson 2000, Erikson and Nerdrum 2001)

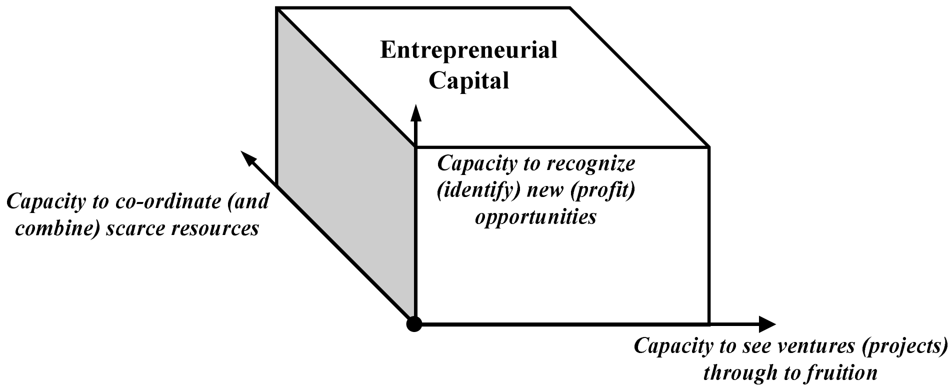


Figure 12: Entrepreneurial Capital (Erikson 2000)

The word opportunism does not represent purely good qualities without controversies, but in this context we can see it just as positively as we see a craftsman; they both have good qualities but a downside as well. In itself, exploiting the opportunity can take two forms: Austrian entrepreneurship focuses on entrepreneurial discovery, in identifying market opportunities where resources could be used to produce output meeting the demand better; and the Schumpeterian entrepreneur, who exploits opportunities by using new combinations of inputs – innovation. (Erikson and

Nerdrum 2001) These capacities to combine and co-ordinate resources are crucial to entrepreneurship and entrepreneurial capital as presented above.

In our context, we are seeking for growth-oriented companies and entrepreneurs. Therefore, we basically rule out the aforementioned craftsmen as entrepreneurs who do not want to accept the challenge and concentrate on the growth as growth-oriented and – in a positive sense - opportunistic entrepreneurs do. In a sense, we can think of their opportunism to be constructive: They fight the paralyzing spirit of those who think everything worth inventing has been invented before and their legendary phrase: "If you're idea is so good, why has not someone done it before?"

To illustrate these qualities we quote Randy Komisar, who talks about entrepreneurs, which are "passionate beyond analysis" (Smith 2001):

> *"I want to see a zealousness to prove themselves and their vision. They challenge current thinking, and the founders will confront a raft of naysayers in the course of building their business. Great entrepreneurs have to be open enough to learn, but they also have to be a tad deaf and blind, because these are irrational acts, sailing beyond the edge of the known world to discover new land. Still, you want as much real-world experience and street smarts as possible, because there is a lot to know about the various aspects of running a business, from product design to financing."*

From the above quotation we also see the other side of the entrepreneurial coin besides motivation and high spirit: the need to keep one's feet firmly on the ground. Similar views regarding the multi-faceted and even controversial challenges the start-up entrepreneurs are facing can be heard from venture capitalists and entrepreneurs themselves. Reg Valin built a successful public relations company in the 1980's and has since invested in several projects as a business angel: "In the early days the entrepreneur has to be everyone: production manager, finance director, salesforce and office administrator. If they take their eye off any one of those balls, the business will fail." (Gracie 1999) This challenge brings us to the subject of entrepreneurial team.

**Entrepreneurial team, networking and social capital**

Early contributors to the subject like Kamm, Shuman, Seeger and Nurick define entrepreneurial team as two or more individuals who jointly establish a business in which they have an equity interest and who are present prior the start-up phase of the firm (Ensley et al. 1998). According to Timmons (1979), the lead entrepreneur brings value to the new venture as the person who identifies the opportunity, though he may also have substantive skills needed by the venture. On the other hand, the skills brought in by the team members complement the skill set needed by the venture but which the lead entrepreneur is either lacking or has no time to exercise. It should be noted that in many cases the lead entrepreneur is what could be called a technical entrepreneur, and for whom becoming the general manager of a technology-based business presented new kinds of challenges (Riggs 1983).

The team is important, as after all, even the best business plan is only a guess and approximation of the future. It is therefore not a map, but can be used as a compass when venturing ahead in the turbulent environment of new high-tech start-up (Komisar 2001b). Komisar states "Following a plan is not the key to start-up success. You have to set a course and constantly question its appropriateness, zig-zagging to avoid the minefields that pop up around every turn while staying as true to your compass as possible" (Smith 2001). As noted by Riggs (1983), a top management job in companies experimenting in high technology is filled with ambiguity, the only consistent characteristic being its variety. Hence, the plan is of no use without a team, which can use it to interpret the market signals and take the measures needed to reach the target. And ultimately, it may be the team, not the leader who has to be in operative charge as already stated by the ancient

Chinese: “He whose generals are able and not interfered with by the sovereign will be victorious” (Sun Tzu 1998).

Networks and social capital are also of crucial importance for the new entrepreneur. Social capital is said to be both the glue which forms the structure of the network and the lubricant which facilitates the operation of networks (Anderson and Jack 2002). This is true both for first and second career entrepreneurs, i.e. those who do not have a significant career before starting their own business and those who have significant experience of working for another organization before doing so (Henley and Cardon 2000). Furthermore, human and social capital are instrumental in providing access to the necessary physical, financial and organizational resources for the new venture (Hart et al. 1997). These form the five different types of capital needed: Human and social capital for the entrepreneur; physical and financial capital needed for the venture; and organizational capital the produces the goods and services offered by the organization (Greene and Brown 1997).

It is said that one’s personal competitiveness equals “What you know” multiplied by “Whom you know” (Norström and Ridderstråle 1999). Entrepreneurs lacking social capital and networks may compensate for this by taking advantage of having a mentor or assembling a powerful board of directors; issues which are discussed later in Chapters 2.4.3 and 2.5.5 respectively. It seems that even the most individualistic and experienced of entrepreneurs rely heavily on their social relationships during the creation of a new business (Brereton and Jones 2002). On the other hand, the reason for becoming an entrepreneur may also be the pursuit of social recognition and other society-oriented reasons as with many Japanese entrepreneurs, in contrast to Silicon Valley entrepreneurs who are motivated by more individualistic factors, such as personal achievement and wealth (Suzuki et al. 2002). Still, of all the countries in the world, Japan is probably the one where social networks are most needed for the success of a new venture.

However, not all the networks and teams work in entrepreneurial measures, and the requirements for the team vary from case to case. As Tim Lewitt, director of Northern Venture Managers commented on the differences between becoming an entrepreneur through an MBO or founding a start-up: “There are many individuals and management teams around that I would be comfortable with to back in a conventional buyout situation who I would not be comfortable in backing in a start-up. A start-up is very much more demanding and calls for a very tough and streetwise individual if it is to work – if there would be more of this type of individual around then I would be doing more start-ups.” (Wall 1995) Hence, Komisar was not the first to bring up the “street smarts”.

All this is in line with the key message of Komisar’s bestseller book “The Monk and the Riddle”: The personal motives and goals of the entrepreneur have to be in line with those of his start-up (Komisar 2001b). Yet according to Drucker (1994) the knowledge of the various things to be known about running a business, the managerial skills required of an entrepreneur, can be presented as a discipline, capable of being learned and practised. Yet it is not necessary for one person to be able to master everything necessary in running the business: It is often better to have an entrepreneurial team instead of just one individual.

Finally, in connection with the team context we should remember that at a certain point, the entrepreneur has to be mature and bold enough to step aside and let other people take over the management of the company. Clinging to the post of CEO was one of the “seven deadly sins” in technology companies as listed in a Finnish trade journal. As commented in the same article by a director Vesa Sadeharju from 3i Finland: “At some stage it is usually beneficial to change the leader and move backstage, serving as someone who shows the direction and builds the culture of the company”. (Lukkari and Hallikainen 2002) This issue is discussed in more detail in Chapter 2.4.2 on “Leadership”.

**Ubiquitous Entrepreneurship**

Apart from academic interest, there are many other activities around entrepreneurship. Numerous how-to handbooks have been written for potential entrepreneurs by the public sector and private authors (see e.g. Tervonen 1996, Baird 1999, Nesheim 2000, McKinsey & Co 2000, Jokilampi et al. 2003, Paloranta et al. 2003). Entrepreneurship is taught by cities and nations promoting entrepreneurship in the hope of new jobs, and even the World Bank is supporting entrepreneurial education in places such as Niger, Bangladesh and Guatemala for the sake of economic growth (Lambing and Kuehl 1997). Entrepreneurship also plays a role in keeping rural areas occupied, as farmers start additional business activities (Alsos et al. 2003).

Entrepreneurship is also taught in universities as a part of academic degrees with textbooks either on the practical level (see e.g. Lambing and Kuehl 1997, Coulter 2001) or more on the academic side (see e.g. Burns and Dewhurst 1996, Bridge et al 1998). And as in the poorest countries mentioned above, students of these universities are also encouraged to take the entrepreneurial step with various initiatives and competitions (see e.g. Ballon 1998, Venture Cup 2004, or “Venture Stables” presented in Chapter 4.2.7). To close the loop, the entrepreneurship programs and courses of universities are also studied by the scholars e.g. to find out the best practices for entrepreneurial training (see e.g. Fletcher 1999, Klofsten 2000).

Public policies are made and organs founded to pave the path for creation of new companies. Public sector activities in this field are of course somewhat controversial, and cannot be considered as the main tool for business creation. And they do not suit all; a anecdotal example of this is given by a nascent entrepreneur with a vocational school qualification and 18 years of age: to be eligible to the entrepreneurial program he would have needed 25 years of age. The company was founded anyway and gives steady income to the young entrepreneur. (Rautio 2002). Entrepreneurship is also strongly affected by public policies on many other issues, such as taxation and financing.

**Summary**

Regarding this study we conclude that a venture needs a dedicated individual or preferably a team of individuals to form the entrepreneurial team. They have to be committed both psychologically and by ownership to the success of the venture, be it new or acquired. Yet they have to keep their feet on the ground, working through all the obstacles and challenges along the way of growth. The entrepreneur or team should also be constantly aware of their own insufficiencies, using various kinds of aides in both operational and strategic issues as well as financing when necessary and preparing even to step aside when this is seen to be beneficial for the company. The operating environment can be made easier by public policies, but these are not in the hands of the entrepreneur and changes are slow.

### 2.3.2 Innovation – the Basis for Business

*“Inventions have long since reached their limit and I see no hope for future developments” – Julius Sextus Frontinus*

Long ago, great inventions and discoveries paved the way for technical development and eased the life of mankind. Harnessing fire and inventing the wheel can be regarded as major advances in technology. And when Archimedes shouted “Heureka” or Newton got an apple on his head, another great discovery was about to be made. As time went by, the number and influence of scientists rose, and the practice of innovation became more intentional. Penicillin and dynamite were no longer invented by sheer luck, even though luck is always helpful in the process.

Innovation is a crucial and central part of business today, and may therefore have several definitions. One of them is an elaborate one given by the European Commission (1995): “Innovation has a variety of roles. As a driving force, it points firms towards ambitious long-term objectives. It also leads to the renewal of industrial structures and is behind the emergence of new sectors of economic activity. According to that definition innovation is:

- the renewal and enlargement of the range of products and services and the associated markets
- the establishment of new methods of production, supply and distribution
- the introduction of changes in management, work organization, and the working conditions and skills of the workforce.”

Another, fairly similar definition states “By definition innovation involves both technical novelty and utility. Every innovation must therefore rest on a new combination of a technical feasibility and an economic demand. To realize this combination some commitment of funds is needed, sometimes small, more often quite substantial. It is the unique characteristic of the innovator that he (or it) is able to recognize both the technological feasibility and the demand, and is also willing to make an investment decision upon this insight.” (Rothwell and Zegveld 1982) Quite practically, this definition brings up concerns on utility, given that the innovation is usually based on existing knowledge improved by resources brought upon by a monetary input.

**Inventions and Innovations**

Inventions and discoveries as groundbreaking as wheel or the force of gravity can scarcely be expected any longer. Occasionally, an odd research laboratory comes up with a principle for fusion energy or a blueprint for the transistor, but most of the companies have to be content with new applications of known technologies or gradual improvements to them - innovations. Not that this is unimportant: The safety razor of King Gillette provided no input to the pool of technologies known to mankind, yet its patented, removable blades settled a major problem for that half of human race whose facial hair has to be cut every day (Drucker 1994). The result was that more people are grateful to Gillette for providing them with a good means to shave than they are to Newton, whose discovery is used by every one of us with or without knowing it. Besides, closer to the theme of this study: only one of them made a fortune with a company still in operation today.[6]

Indeed, in order to exploit the opportunities afforded by gradual advances we should cultivate continuous innovation instead of expecting occasional grand ideas. This division between invention and innovation - and between research and development - is illustrated by the Technology-Source Continuum shown in Figure 13 below. Invention – the conception of a brand new idea – is the product of research. This may yield economic income, but pursuing it is a risky long-term activity. On the other hand, innovation – the exploitation or introduction of a new idea – is the product of engineering. This introduction should be guided by an understanding and appreciation of market needs. (Riggs 1983).

[6] Furthermore, we could claim that John Walker of Durham finally harnessed the fire as late as 1827 by making the first friction matches, but he was not interested in patenting this quite essential innovation, which is now commonplace without us recognizing it.

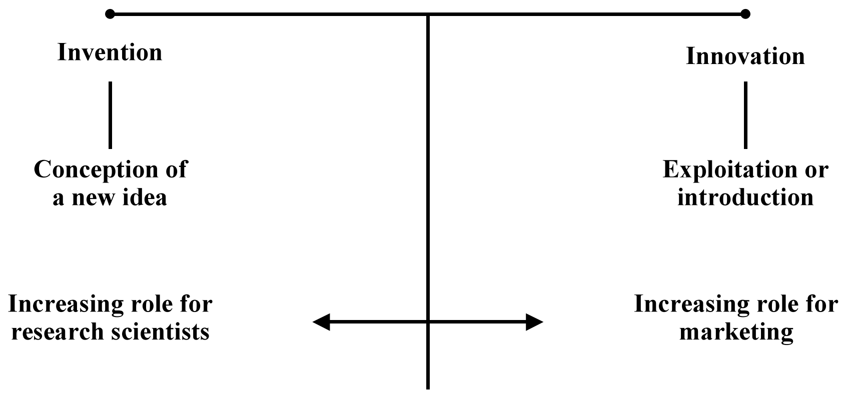


Figure 13: Technology-Source Continuum (Riggs 1983)

The boundary between invention and innovation is both unclear and irrelevant. What is critical is to realize that both are important. The closer the applied engineering end of the continuum, the greater the need for close coupling between marketing and the technical function. Also, the management style and process will differ according the position on the continuum. But despite what is written in the annual reports of many companies, glorifying their activities in research and development, most companies are more or less completely concentrated on development. (Riggs 1983)

Similar notions were also considered by Ansoff and Stewart (1967), who contrasted the characteristics of R-intensive companies with those of D-intensive companies, as they called them. A summary of these characteristics is given in Table 2, where the contrast points out the much greater need for market coupling in the D-intensive companies. The venture capitalist’s point of view is clearly manifested by Vesa Sadeharju, director in 3i Finland in an interview: "The biggest mistake is to develop technologies separately from the marketplace” (Lukkari and Hallikainen 2002).

Reflecting this in practice it is comforting to hear that companies feel the most important source for their innovations or the most prominent linkage group in their innovative process are their customers, as noted by Kolehmainen (2003). Interestingly, the second most important linkage group in this study conducted on new media and software companies were the suppliers of development tools and environments - evidently, your tools have to allow you to build the products your customers crave.

Table 2: Characteristics of the engineering function in R-intensive and D-intensive companies (Ansoff and Stewart 1967)

| *Research-intensive Organizations* | *Development-intensive Organizations* |
|---|---|
| Work with infinite design specifications<br>"Broadcast" objectives and market data among technical people, rather than channel specific kinds of information to individuals<br>Nondirective in work assignments<br>Maintain a continuing project evaluation and selection process<br>Stress the regocnition (interpretation) of significant results<br>Value creativity over efficiency | Well-defined design specifications<br>Highly directive supervision<br>Sequential arrangement of tasks<br>Vulnerability to disruption from changes in objectives or specifications |

Apart from rare cases such as certain bio-tech start-ups, most start-ups are D-intensive. Therefore, we should also concentrate on innovation, not invention. This is already risky enough, as only minority of development projects result in commercially successful products and processes (Riggs 1983, Naumanen 2002). And we have to keep in mind that the start-up has only one chance to prove its worth.

Drucker (1994) puts innovation into action with more practical terms by noting that "Entrepreneurs innovate. Innovation is the specific instrument of entrepreneurship. It is the act that endows resources with a new capacity to create wealth. Innovation, indeed, creates a resource." His further reasoning includes pointing out that every plant is a weed and every mineral just another rock until a use is found for them. One would think that innovations are hard to come by. Nevertheless, Drucker (1994) talks about *Systematic Entrepreneurship* and *Purposeful Innovation*. His principles for the practice of innovation have been established in writing with a total of seven sources for innovative opportunity, of which the three last ones are completely external to the industry in question:

- The unexpected: Surprising successes or sudden changes always make room for innovation.
- Incongruities: Mismatches between real and perceived needs, controversies in process and so on can be exploited with innovation.
- Process need: The development of the automated switchboard was initiated in 1909 when estimates showed that every female American will be needed to work as an operator in 15 years.
- Industry and market structures: Utilizing the breakpoints in slowly changing industries and markets.
- Demographics: Changing demographic conditions such as the rising buying power of teenagers and urbanization in Central America call for innovative new business models.
- Changes in perception: The glass may be either half full or half empty – Americans are healthier than ever, yet due to their dissatisfaction they spend more and more on their health.
- New knowledge: The summit and wet dream of entrepreneurship, yet it causes the biggest risks and inertia. The traditional kind of innovation known to laymen.

On top of these, he also accepts the existence of "The Bright Idea"; noting that they represent seven or eight out of every ten patent applications. Still, the bright ideas are the riskiest ones with the highest casualty rates: no more than one out of every hundred patents for an innovation of this kind earns enough to pay back development costs and patent fees. To compensate these quirks of fortune, he defined the previously mentioned concepts of systematic entrepreneurship and purposeful innovation: In short, one should seek for substances around oneself which create economic value as resources. Bauxite was of no use until people found a use for aluminium, for which it is the ore. Similarly, mineral oil was regarded merely as a substance making the soil infertile until it was re-defined as a valuable resource – not to mention the penicillin mould – hardly taken as a resource at first sight. (Drucker 1994)

Christensen (1997) evaluated innovations by dividing them into two main categories in his landmark book, which is unofficially said to be the Bible of the Nokia people (reference withheld). Essentially, he differentiates between the sustaining innovations, which are gradual improvements to existing products, and disruptive technologies, which re-shape whole industries and markets by their emergence. By numerous examples he points out his idea about *Innovator's Dilemma*, according to which the established companies in mature trades have to keep up with the pace of the technical development in their industry resulting in that the level of technology grows faster than the customer needs. When a lower category need emerges, it is satisfied by smaller companies or start-ups for which the size of this emerging market is enough, while the more established companies continue fulfilling the needs of the mainstream market. Eventually, the technology used in the lower category products advances to a point where it also satisfies the needs in the higher category, replacing the established companies with this "killer application".

### The Entrepreneur's Role in Innovation

Small enterprises with eager and innovative entrepreneurs are a major source for innovation. These start-up innovators have lots of self-reliance and risk tolerance arising from their earlier work experience. Sometimes it appears that the end result, especially in monetary terms, is not of great importance to them compared to the process of making something happen. Personally, they may even identify themselves with the company, which in some cases may result in their ego being involved in the management of the company in innovative processes, hindering the vision. Yet the most successful innovators have noted that it is important to share: not to want to own the ideas oneself, and to be able share control. (Hellström et al. 2002)

On the other hand, preceding the ideas of disruptive technologies as spelled out by Christensen, Schumpeter (1939) noted that while entrepreneurs play a significant role in the establishment of new industries, later on the innovation calls for larger firms because of the high development costs and market power required to utilize the innovation. Moreover, the role small firms can play depends on a number of factors specific to the technology itself and to the structure and requirements of the market place. Small firms are therefore unlikely to play an important part in innovation where capital costs are high and where large-scale economies are necessary, but may play a significant role in highly segmented markets for specialist products. (Rothwell and Zegveld 1982, cf. Christensen 1997) The difference between big corporations and agile start-ups can be illustrated by an ancient wisdom: "When torrential water tosses boulders, it is because of its momentum; when the strike of a hawk breaks the body of its prey, it is because of timing" (Sun Tzu 1998)

An interesting observation on an especially eager group of entrepreneurs was made by Schrage (2003), who identified a special kind of enthusiastic hobbyists, who act as creators and consumers at the same time, adapting and adopting the product in the process. These "amateur innovators" have their limits, though, and as soon as any real innovative steps are made the hobby becomes expensive and the hobbyists may have to turn professional to pursue their ideas. The essential point, however, is that innovative firms gain their keenest insights from these innovative customers.

Not all of these traits presented in the foregoing are exactly optimal from an investor's viewpoint: using the company as their alter ego and being more interested in technological advancement than commercial success is not what e.g. venture capitalists would prefer in an entrepreneur. This is exactly why managerial issues are of great importance in a start-up company as well, as is discussed in Chapter 2.4.2. Luckily, modern management science and practice recognize the importance of entrepreneurship and innovation in both ways: the single most important reason for established companies to fail is their lack of innovation, and on the other hand incapable management is the most common reason for the demise of start-up ventures (Drucker 2002).

Sometimes, a venture capitalist may be a good partner for an innovative start-up company. The constraint caused by a high capital requirement, as noted by Rothwell and Zegveld, may be overcome with investment from venture capitalists; either patient as those funding biomedical start-up companies with lengthy development process, or over-eager as those who used to fund the heavy marketing needed to commercialise many of the esoteric dot-com ideas. Yet this last issue has changed fundamentally and also in a broader context, as noted by Amit Singh, co-founder and CTO of Peribit Networks, Inc.: "The VC's have raised the bar of what they think is truly innovative and what has value". Hence, they will only fund the start-ups that can prove there is an immediate demand for their products or services (Rendleman 2002). This development was already visible in advance, when Sapienza et al. (1994) noted that VC's are focusing their attention to where the help is most needed and the likelihood of big payoff is the greatest.

Finally, we should not forget the power of an example and the momentum of the environment as enabling forces for innovations and commercialising them. Just as fledgling entrepreneurs get inspired by the success stories (Autio et al. 1989, EVCA 1999) and a local "engine company" can smoothe the path of a new start-up by facilitating its market entry (Sorvisto 2003), regional innovation networks may substantially improve the local innovativeness atmosphere. This has been exceptionally evident in the Finnish Oulu Region, where the founding of the university in 1959 started a long path of development, resulting in the population increasing three-fold and Oulu becoming an undisputable member of the key technology centers in Finland due to its high concentration of high-tech research, companies and jobs. (Nummi and Lahenius 2003)

To summarize, an innovation is the basis for most emerging growth ventures, and also vice versa: new ventures offer a good breeding ground for innovations, be they subtle improvements or new technologies which will disrupt the dominant market. Most start-up companies are development-intensive as opposed to research-intensive, aiming to exploit an innovation or introduce a product idea in the short-term rather than make a groundbreaking invention in the long run - one obvious reason for this being the prohibitive amount of time and money needed for the latter. It should be noted that despite its creative nature innovation can be done systematically, and many support mechanisms ranging from governmental policies to venture capital investments exist for this.

### 2.3.3 Venture – the Vehicle to Market

*"Radio has no future." – Lord Kelvin*

In order to commercialize an innovation, a venture is needed in the process. One of the multiple definitions for the word *venture* given in Webster's dictionary is "a business enterprise or speculation in which loss is risked in the hope of profit". In general, the other ten definitions for the word include risk or adventure in some form. According to the same volume, in addition to meaning a business firm, *enterprise* refers to "a project undertaken or to be undertaken, especially one that is of some importance or that requires boldness or energy". An enterprise referred to in the venture capital literature as "the first venture" is the expedition of Columbus, and it definitely suits this definition.

The biggest enterprises are usually corporations, public companies not run by an entrepreneur but a CEO elected by the board set by the owners. As noted earlier in reference to the words of Drucker (1994), many of these conglomerates try to utilize entrepreneurial activities and approaches. Hence, we can say that entrepreneurship – or intrapreneurship, as the term coined by Gifford Pinchot III calls it - resides in some of them. Yet, when pondering upon the definitions of entrepreneur on page 33 we can also see that not all small businesses are entrepreneurial, either: some of them are less venturous than the others.

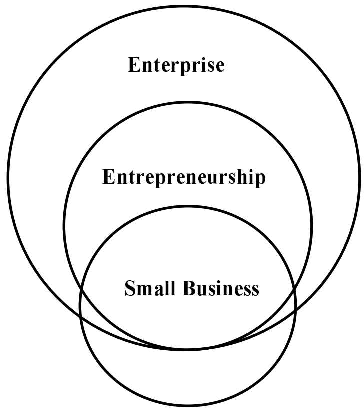


Figure 14: Relationship between Enterprise, Entrepreneurship and Small Business (Bridge et al. 1998)

The most interesting ones for this study are those adventurous business enterprises which have been put together recently, seek to grow and are based on technology. An established term for this group or type of companies is New Technology-Based Companies, or NTBF for short. Definitions of this vary in the literature, and earlier e.g. Wetzel (1983) referred to small, technology-based firms (STBF's) and their contribution to job creation, technological innovation and other economic benefits, while Kazanjian defined his growth model for technology-based new ventures, or TBNV's (Kazanjian and Drazin 1989). Also, we should note that a widely used cut-off point for a new venture is that it has been established maximum of eight years ago (Olson and Bokor 1995). Hence, the writings of new companies often speak of *young* companies, not necessarily new ones.

Even though the growth-seeking NTBF's are in the focus of this study, there is no reason to limit the thinking only to them. It has been argued that every company possesses growth potential and would thus benefit from venture capital funding (Harding 2002). Family companies, lifestyle companies, service sector and franchisees could all benefit from outside advice and capital for development or expansion, even though the needs may not be as manifest. New opportunities emerge, and society needs those who are willing to tackle them.

But what is it, then, that makes the company a *Venture*, where 'loss is risked in the hope of profit'? How are these companies founded, by whom, and what is the importance of growth? Let us evaluate these issues next: The creation of new businesses, types of these new companies and the factor called growth.

**New Business Creation**

As noted earlier, the entrepreneur needs a company, a venture to commercialise his product or innovation. Also, from the perspective of society, it is accepted that the role of new businesses is crucial in creating new jobs, thus compensating for the diminishing need of workforce in e.g. smokestack industries (see e.g. Drucker 1994, Lawson 1994). But where do these ventures come from in practice? The post-dot.com recession inspired one writer to suggest that everyone should put together a company as their evening pastime, just to be prepared for the worst – to be proactive rather than reactive when losing one's job (Parantainen 2001). This is more of an anecdotal overkill as definitely not everybody is suited for being an independent entrepreneur, not to mention the leader of a growth business (Almgren and Lindfors 1996a).

Creating a new business is not as straightforward as it sounds. When asked, many individuals claim to have intentions of being their own masters and working on their own, as entrepreneurs. Still, leaving a permanent job with steady income and putting one's savings into a – no matter how self-managed - risky venture is not for everyone. In established businesses with years of traceable track record, the risks can be calculated in advance with decent certainty. Furthermore, middle or senior managers tend to avoid risk, since the last thing they want to do is fail. However, as noted by Komisar, the start-up game is quite the opposite: "if it is not big and potential enough that it is worth failing at, then it is not worth spending one's time in the first place". Therefore, in the ultimate Silicon Valley-style enterprising the entrepreneur "goes for broke", i.e. is looking for either great success or bankruptcy with no alternatives in between. To put in other words: "There is no hedging in the start-up game". (Smith 2001)

It is therefore understandable that the majority of people want a monthly salary for a nine-to-five job as opposed to an unsteady salary and future for countless hours as members in an entrepreneurial team in a new venture. Hence, the further one wanders towards actually founding a venture and thus becoming an entrepreneur, the clearer the risks become and the more dropouts there are on the way towards entrepreneurship (Alsos et al. 2000). This business formation process is illustrated in Figure 15.

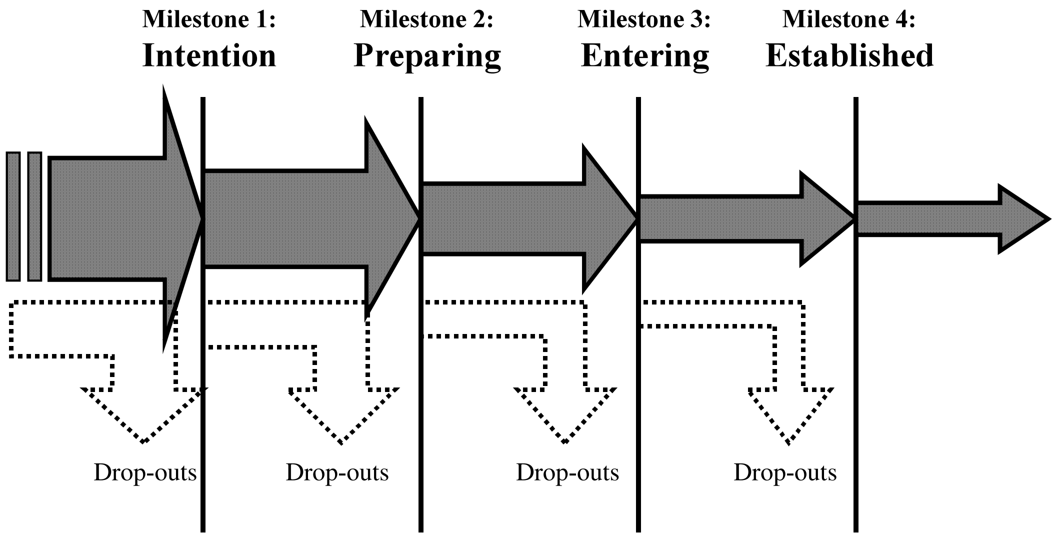


Figure 15: The Business Formation Process (Alsos et al. 2000)

A substantial portion of potential entrepreneurs do not manage to make it to an established business. According to Alsos et al. (2000), many young adults possess entrepreneurial intentions, but with a little more age would have more experience, equity and other resources needed to create a business. Making training, financing and transfer of experience more available to these young individuals would result in more enterprises as an outcome, since - according to the study – given necessary resources, young individuals were as successful in establishing a business as their more experienced counterparts.

Reflecting the Business Formation Process model, the point of actual creation of a new venture can be argued to be very early, as the moment when the desire for entrepreneurship is first recognized or the idea for the new venture occurs. It can also be regarded to be fairly late, i.e. when the company has established itself and has broken even or had its first profitable year. Which of these events should be regarded as the true inception point can be argued without resolution, as a venture typically emerges from a series of such occurrences spread over time its existence becomes progressively more established. (Vesper 1980)

Motives for entrepreneurship and triggers to the start-up decision also vary a great deal. Birley (1996) has identified nine different factors, not necessarily mutually exclusive. Some of them are internal, emerging from the person himself, while others are pressures coming from outside. Also, one can divide the factors to push or pull: and example of internal push would be a physical illness or disability making the individual unable to obtain regular employment, whereas being laid off certainly is an external push. Similar examples of internal and external pull are e.g. an idea occurring to the individual or a benevolent employer clearing the path to entrepreneurship by making resources available.

This last example actually brings forward an important source for new ventures, namely spin-offs and spin-outs. In many cases, a business idea originates inside an existing company, and as a result a new company is founded. This may happen in a friendly and cooperative manner, which is the case if for instance the originating company does not see the new innovation as something worth pursuing. It may also happen in a more disruptive, hostile way, if a group of workers resign to set up in competition with their former employer. Nevertheless, nurturing the internal ideas is one of the basic drivers in corporate venturing and can be a used as a competitive tool by large corporations (Chesbrough 2002). Importance and need for spinouts is also more and more recognized among universities (Nicolaou and Birley 2000).

Regarding the motives for establishing a new venture we must also remember the possibilities it offers for the individual. Opportunities for new entrepreneurs exist ubiquitously, and evidently there is a business born every minute and even an industry once in a while. A good example of this birth of a new industry is for instance the emergence of welfare services in Finland. Originally, the experimental legislation in the late 1990's gave households rights to tax deduction on certain household services bought from companies. The goal was evident: to boost the use of the service sector and promote opportunities for self-employment as people were supposed to become independent service-providers. At the same time, people are getting older, creating more need for welfare services in developed nations both in the private and public sectors. When put together, these trends form a new basis for entrepreneurial activities in this sector, and as a proof of maturity reached within just a few years, consolidation of companies has already started. (STT 2001)

**Factors and Definitions of Growth**

In the foregoing we discussed creating new businesses. Most, although not all, new companies are small, but being a growth company is not limited to small companies. Larger companies can also be growth companies, and from numerous studies on the subject it can be seen that there is no significant relation between size and growth (Storey et al. 1987). Nevertheless, the context of this study is about developing small companies until they are no longer small. Therefore, to facilitate further discussion we define what is meant by small company and growth.

The definition of what is meant by a small firm varies widely between countries, and even within countries from one fiscal authority to another (Rothwell and Zegveld 1982). National definitions may speak of up to 49 employees as is done by DTI in the UK, including the micro firms which have less than ten workers. At the same time, the Companies Act of 1985 adds constraints to the turnover and/or total of balance sheet to the equation. The Small Firms Loan Guarantee Scheme, Corporation Tax Law and the Bank of England have their own, slightly varying rules on the subject. (Bridge et al. 1998)

Others have noted the same looseness in the definition of small company and boldly applied their own definitions appropriate the context (Hay and Kamshad 1994). Nevertheless, there is no reason why we could not keep the European Commission definition as our guideline: A small company has fewer than 50 workers and maximum of €10 million in turnover. Other regions are duly comparable to this with appropriate accuracy. Microcompanies are those companies with less than ten employees and €2 million in turnover. On the other hand, the same authority defines the upper limits of a medium-sized company to be 250 workers and €50 million in turnover (European Commission 2003)[7]. Thus, in context of growth we could think that the mindset inside a new venture, if growth-oriented, has to be to work itself out towards the upper limits of small company: having at least 50 workers and turnover of more than €10 million.

Company growth is typically measured in terms of sales, employees or assets, with sales growth being the most typical measure for young technology-based companies (Salonen 1995). Still, as single metrics are often inappropriate performance indicators for these companies, various aggregate metrics of growth and success have been devised (Miller et al. 1988, Feeser and Willard 1990). The growth of an organization can also be considered to refer to its development and the simultaneous improvement in the quality of its operation, something akin to what happens inside the mind of a child when becoming an adult (Penrose 1995).

In this sense, it can be considered that even a one-man company can grow consistently while staying a one-man company, as its operation becomes more efficient and the only worker accumulates more experience. Combining the two above we can conclude that an organization is growing if there is a positive change in its operation, be it quantitative or qualitative (Laukkanen 2000). In this study, however, we are interested in companies which aim at fast growth when measured by quantitative standards: amount of sales and number of employees. This brings forward the *need for external funding to finance the growth.*

On the other hand, as noted earlier, a growth company may already be of medium or large size. The focus of this study, however, is on early stage companies, as growth companies the size of Nokia or Dell have their own ways of dealing with growth. Nevertheless, both them and the smallest start-ups all have to deal with growth and the challenges it brings to management. Well known studies and models have been presented on this issue by Penrose, Kazanjian, Maidique and Patch or Churchill and Lewis to name only a few (Autio 2000, Burns and Harrison 1996).

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[7] It should be noted that the turnover figures for small and medium-sized companies went up from €7 million and €40 million in the European Union SME definition as recently as in 6th May 2003 when Recommendation 96/280/EC was replaced.

The Kazanjian model of the growth of technology companies postulates that technology-based new ventures, or TBNV's, evolve through four discrete growth stages: 1) Conception and development; 2) Commercialization; 3) Growth; and 4) Stability. The dynamics of these companies pose challenges to traditional management models in such organizations, and the problems, such as marketing, strategic positioning and external relationships, vary significantly depending upon the stage of development of the company. (Kazanjian 1988, Kazanjian and Drazin 1989, 1990) Another well known model is that proposed by Greiner (1972) and illustrated in Figure 16 below. [8]

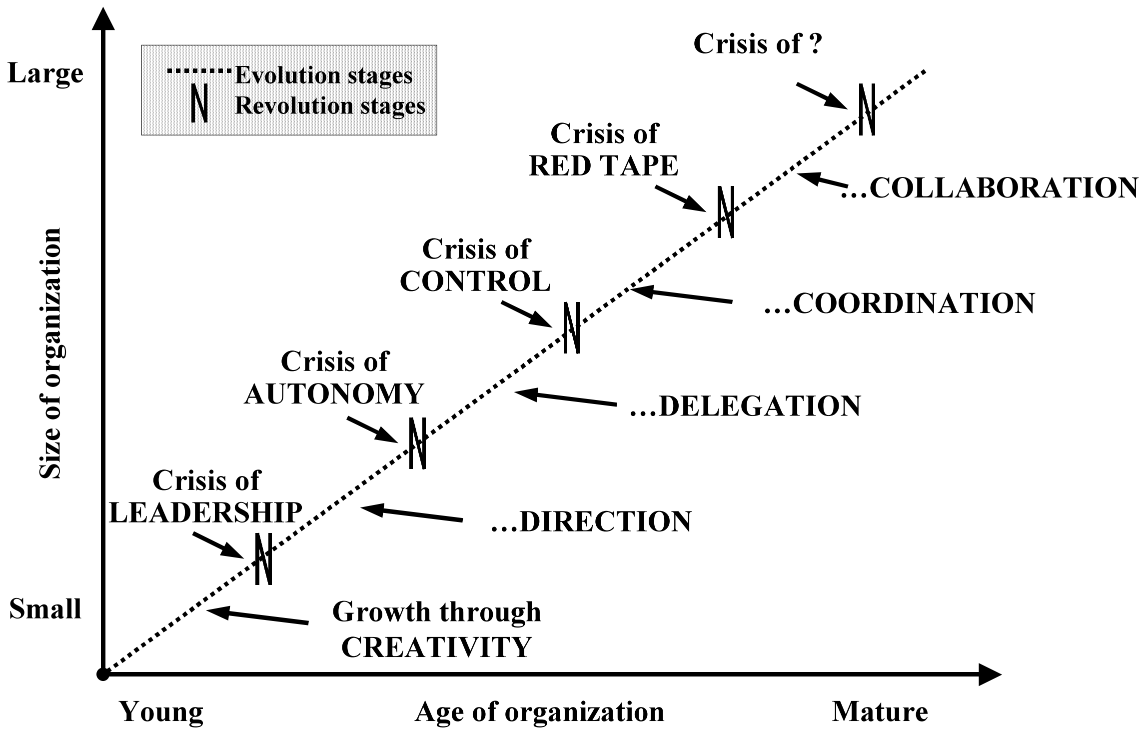


Figure 16: The Five Phases of Growth (Greiner 1972)

According to the model, the growth of a company goes through alternating periods of evolution and revolution. In the birth stage of the company, the emphasis is on *Creativity*, until the increased number of employees can no longer be managed through informal connections and are not motivated by intense dedication to the product. This leads the managers to long for the 'good old days' and onwards to the *Leadership Crisis*. At this point, the normative solution is to locate and install a strong business manager who can pull the organization together and set the *Direction*.

While the new directive techniques channel the energy of employees more efficiently into growth, they eventually become too restrictive for the lower-level managers who feel torn between following procedures and taking initiatives of their own. This results in the *Autonomy Crisis*, resolved by *Delegation*: greater responsibility given to the operative managers while top management sticks to management by exception. Eventually, the successive growth leads into the *Control Crisis*, as the top management feels that they are losing control over the highly diversified field of operation.

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[8] For a version adapted to technology companies see Autio (1994).

At this stage, formal systems should be put into effect for achieving greater *Coordination*. Formal planning procedures are introduced and results reviewed regularly, staff personnel hired to the headquarters and the growth boosted in general through more efficient allocation of the company's limited resources. This will work well until the lack of confidence and communication creates the *Red Tape Crisis* between the line and staff. Line managers resent heavy staff direction from those who are not familiar with the local conditions, and on the other side the staff complain about uncooperative and uninformed line managers.

The final stage of the Greiner model is so far the *Collaboration* phase, overcoming the red tape crisis by emphasizing greater spontaneity in management action through teams and the skilful confrontation of interpersonal differences. Social control and self-discipline take over the formal control. What happens after this, and what is the next crisis to appear was unknown to Greiner, who noted that many large companies in the US are now at this stage. He did propose some possibilities for the next steps in the model as it was of interest to his study. The present study, however, is more interested in the other end of the line: the first stages in company growth.

Both the models depicted above bring forward imminent challenges associated with growth and suggest that growth takes place in stages, between which there are revolutions to a certain extent. These factors are also supported by notions from practitioners, including Vesa Sadeharju of 3i Finland or Randy Komisar, the Virtual CEO, presented elsewhere in this study. The crisis points have also been noted by studies; in a survey done on 400 small companies in Sweden, many managers set the upper growth limit at 5-9 employees. After this, the deterring forces override the motivating incentives, and psychological reasons for growth seem weak. (Davidsson 1989) Others note that breakpoints usually occur around five employees and again at 20 employees. Going beyond 20 employees often means that the way the business is organized has to change. (Burns and Harrison 1996)

Growth as seen in this study combines the qualitative growth as suggested by Penrose and Laukkanen earlier, revolution-based growth models of Greiner and Autio and stages of company development as described by Kazanjian or Bell and McNamara (1991), and is close to the investment round thinking of a venture capitalists, in which context Benjamin and Margulis (2000) differentiate between nine stages of development for the companies seeking funding: Seed; Research & Development; Start-up; First Stage; Expansion Stage; Mezzanine; Bridge; Acquisition/Merger and Turnaround. Baird (1999) simplifies this by combining his equivalent ten stages to four groups of financing: Seed; Early-Stage; Expansion and IPO/Merger/Buyout financing.

Table 3: Stages of Company Development

| *Kazanjian: Growth Stages of a Technology-Based New Venture* | *Bell and McNamara: Operational Stages of Company's Growth* | *Baird: Stages of a Company's Growth (financing rounds)* |
|---|---|---|
| Conception and development | Concept | |
| Commercialization | Seed | Seed |
| | Product Development | Early Stage |
| Growth | Market Development | Growth |
| Stability | Steady State | IPO/Acquisition/Buyout |

Combining the perspectives of Kazanjian (1988), Bell and McNamara (1991) and Baird (1999) we end up with the above table. Based on these views, five stages can be differentiated: Concept; Seed;

Start-Up, Growth and Mature. Conceptually, in our context, growth as a challenge is about *growing to a new level as an organization* - growing from one investment round, and hence company development stage, to another. The actual challenge comes not from the figures *per se* but from moving from a concept with business plan to a seed-stage company with an entrepreneurial team, or guiding a start-up company on the verge of growth through the fast growth and transforming it into a company eligible for public listing or a trade sale.

One key driver in growth especially regarding technology companies is the timing of the market window. They are racing against other providers of the same or competing technology. These companies cannot be patient and grow organically. If they do, either the market window will close before they get in or the competitors have already shared the market. Hence, technology companies need to *grow to attain a position in a new or growing market before competition.*

Companies in the early stages in most cases need support to survive through growth, especially when happening on excessive intensity. Early-stage managers, especially in the case of a founder-entrepreneur who is the original innovator and centered on creativity, seldom have the time and experience needed to cope swiftly with growth, not to mention to fully utilize the growth potential as would theoretically be the in best interest of the company. This is why the company is advised to take advantage of assistance available from outside: advisors, mentors and incubators.

In fact, lack of management team's ability to manage further growth has been identified to be one of the key restraints to growth. Lack of managerial capacity in general has also emerged as an issue starting from Edith Penrose in the 1950's, working on many levels: the pool of managerial experience at management's disposal; the rate at which new management resources can be added and integrated; and the speed with which proven managerial experience can be shared. (Hay and Kamshad 1994)

Other limiting factors can be divided into external and internal factors, of which – apart from intensity of external competition – the internal factors were found more important by the respondents in the study conducted by Hay and Kamshad (1994). The most important constraints varied between industries and manager objectives, but those cited most were the need to change the ownership and control of the firm and losing track of the firm's operations. Constraints to growth also include fear of reduced employee well-being and loss of supervisory control (Davidsson 1989). In general, all these limiting factors and fears seem quite plausible and understandable.

Therefore, not all companies want to grow rapidly. The Finnish SME Barometer report for fall 2002 showed that only six percent of small and medium-sized companies were pursuing fast growth, in which they saw many risks. The rest want to grow steadily and in a controlled manner. Many trades had inherently very limited growth potential anyway. Nevertheless, fast growth of existing companies is seen as the most promising way to improve employment. (Rainisto et al. 2002)

Growth potential is not only dependent on business type, as there are also differences in the growth aspirations of the entrepreneurs. As a firm grows, it becomes necessary to spread managerial control and make operations more formal, at the same time diluting the financial independence and ownership as external investors come in. This is the price for the founders to pay for growth, and not every entrepreneur is willing to pay it. However, the existing research on entrepreneurship by and large assumes the growth orientation without questioning it. (Arenius and Parhankangas 2000)

An interesting notion here, however, is that contrary to the general belief that a rapidly growing new firm would quickly outgrow the founder's managerial capacity, no clear evidence of professionally managed firms growing faster than those run by owner-managers was found in a study conducted on fastest-growing US companies. Founder-managers were found to be able to adapt to the increasing complexity of rapid growth without sacrificing performance and losing control. (Willard et al. 1992) Owner's propensity to expand their business is also the strongest factor differentiating the fast-growing companies from the slow-growth ones (Smallbone et al. 1993).

On the other hand, growth is a very high priority especially to non-owner managers sitting at the helm of SME's, who need to show their worth in the position. This may also explain their tendency to favor somewhat riskier growth strategies than their non-managerial counterparts. (Hay and Kamshad 1994) But according to Mintzberg and Waters (1982) not even the high-potential companies should be pushed to grow too fast. They noted a model of alternating periods of high growth and latency, and a that successful entrepreneur not only accepts this but also utilizes the pauses for reconstruction and recovery. This fits well with the Greiner model, technology adoption life cycle theory and renown concept of the chasm between the early market and mainstream market and the tornado following the latency (Moore 1995, 1999). In other words, high-tech firms should be prepared for snags in the market.

All in all, growth is admittedly challenging for a company and it has been studied a lot. In our context we are not that interested in the numerical, absolute growth of a venture, but associate the challenges in growth venturing more to the imminent revolutionary change which happens when the company transforms its operation from one stage of development to another and the inherent need for outside financing. To summarize the elements of our definition, a growth company:

- needs external funding to finance the growth
- is growing to a new level as an organization
- has to grow in order to attain a position in a new or growing market before competition.

As noted above, not every entrepreneur wants to face these challenges and make his business grow; growth is more associated with certain kinds of companies.

**NTBF and Other Types of Companies**

As noted by Kolvereid (1992), while growing new firms receive considerable attention in the literature, most firms are born small to stay small. While microeconomic and stage-of-development theories assume growth as a natural phenomenon, we can consider it to be a decision made by the founder of the company. The growth aspirations of entrepreneurs vary depending, for instance, on the objectives of the entrepreneur and between the industries. But we can also think of the variations he found as a chicken and egg problem: while entrepreneurs with high growth aspirations tended to have founded manufacturing companies rather than service firms, is this in fact a feature of the founder or the industry? (Kolvereid 1992)

These 'born small to stay small' companies are often referred to as lifestyle companies (see e.g. Virtanen 1996, Baird 1999). They reflect – or even are - the lifestyle of their proprietors, who basically want to be their own masters and do not want any additional complication to this. No matter how much effort is put into company development, a self-employed barber is a craftsman and will only be able to cut the hair of so many heads per day. A corner video rental shop or fast-food stand will attract customers from the other side of the street but hardly from the other side of the city. Even among small and medium sized technology companies, majority wants to grow within the limits of organic growth, without external funding (Lumme 1994).

A company may also be founded based on the need to have a job. In these cases, a minor bank loan is usually enough to get started, and in many countries state-subsidized starting loans are available for individuals who want to be self-employed. So-called micro-finance programs have also been used to facilitate self-employment in many developing countries, in a similar manner as was done successfully e.g. in Ireland in the 18th and 19th centuries (Hookway 2001, Hollis and Sweetman 2001). These *Income-Compensating* or *Lifestyle Companies* do not ignite the venture capitalists or business developers, unless there is a plan for growth through franchising or such.

There is also another direction from which lifestyle may affect the company. In some cases the fast-growing high-tech companies could be called lifestyle companies since many managers aiming for high growth were concerned not so much with growth *per se*, than with building a business which would remain capable of supporting a particular lifestyle (Hay and Kamshad 1994). This was also implied in the lawsuit in which the funders of Idealab (see case description in Chapter 4.2.14) sued its founder and his wife, claiming that much of the money had been spent to support their glamorous lifestyle (Meyer 2002, Kaplan 2002). This is definitely not what is meant by lifestyle company.

At the other end of the growth potential scale we have another type of venture: *New Technology-Based Firms*, or NTBF's. Originally, large scale NTBF creation was, in the main, a US phenomenon, and they have had major impact on the economy in the United States. Later, other nations have seen the importance of NTBF in the economy, and many of the obstacles to their creation have been removed. (Rothwell and Zegveld 1982) The core idea of this study is to find ways to make start-up companies grow faster and more reliably, it is natural that the focus is limited to growth-oriented companies, such as NTBF, not the lifestyle companies.

An extension of NTBF is the term "[Business] Gazelle" coined by David Birch of Cognetics Corp. and defined as a small to medium-size company with a base revenue of $100.000 or more and growing at least 20% annually. They typically double in size within four years but only 6% have more than 100 employees. Although relatively small, they play a pivotal role in the overall U.S economy as they have explosive potential and ability to sustain rapid growth. Like many other, Gazelles suffer from the effect of the equity gap slowing down their growth, especially for those located in rural markets. (Gregory 1998)

One definition of a "technical" company states that a distinguishing feature is that technology is a key element of its business strategy. Technology is certainly not the sole strategic element or even necessarily the dominant one; market, financial and manufacturing considerations also drive the overall business strategy. But in a high technology company to formulate strategy without careful attention to the opportunities offered and threats posed by evolving technology would be analogous to assembling a symphony orchestra without a string section. (Riggs 1983) This dependence on technology introduces high risk and provides challenges to the entrepreneurs, not least with the financing of the company.

Since the projected future income will not suffice to pay the expenses of a growing NTBF, outside capital funding is practically built into them. They will need funding, perhaps in several rounds, before they have put together the team of executives, finalized product development, opened the market and broken even. Still, even though companies with high growth potential represent only a small percentage of all small and new companies (Davidsson 1989, Kolvereid 1992), their role in creating jobs and maintaining employment as well as economic growth in general is of great importance (Riggs 1983, Drucker 1994).

**Summary**

To put it simply, more new companies means more self-employed people and therefore less unemployment. On the other hand, having more companies and entrepreneurs also provides more chances for growth companies to emerge. Raising the number of new companies founded and facilitating the growth of those of them willing to grow will result in economic gains for society, as production and employment status are improved.

Paying attention to the growth potential is important for several reasons. First of all, while large companies are employing fewer people by the year, growth companies can create more jobs at a fast pace. Second, utilizing the growth potential generally means a need for outside financing. Third, the entrepreneurs in growth companies usually have high growth aspirations, but will have substantial challenges in managing the growth. Therefore, the growth companies can use outside financing and advisors to improve their outcome.

## 2.4 Management

*"There's a big difference between smart luck and dumb luck." – Randy Komisar*

Since management was invented and strategy redefined from the art of war to the art of managing corporations, there has been no shortage of books written about these subjects. Universities teach management, strategy and even leadership, mainly in the context of large corporations. But there is also a lot to manage in small companies, non-profit organizations and such.

Management, strategy and leadership are just as important skills in all these environments, and absolutely essential in start-ups, which only get one chance to survive. Yet, the ingredients of these skills vary from place to place, or organization to organization. Start-up managers cannot easily be taught in big classes in business schools, and the corporate managers cannot easily mimic the practices used successfully in entrepreneurial start-ups. Many large companies prosper because they have designed policies and procedures for managing complex large scale operations. It is a critical competitive advantage to them, but does not adapt to start-ups at all.

Psychologically, creating and managing that sort of operation is 180 degrees away from the psychology of taking risks around launching new ideas (Komisar 2001a). The entrepreneur needs a vision of things which do not yet exist, and a very diverse set of business skills to realize this vision. To a teacher the whole concept may seem absurd, as much of these skills - or business wisdom - is based on experience, intuition and instinct, which can be taught only through practice.

The differences between management of small and large companies have been evaluated by Rothwell and Zegveld (1982), who noted two constraints limiting the capabilities of large corporations. First of all, the small high-tech firms are often controlled by dynamic entrepreneurial characters who react swiftly to take advantage of the new opportunities. Large firms, in contrast, often possess a management structure that stifles entrepreneurial endeavor, a fact which has been recognized and fought against in the US since the seventies. Secondly, corporations are often controlled by risk-averse accountants, and decision-makers implement formal techniques for project selection and evaluation, containing an inherent bias against high-risk innovations. Contrary to this, the entrepreneurs who have founded their company on a particular innovation are perhaps more amenable to undertaking subsequent high-risk innovation projects.

The proverb says: "There is no project so promising that a capable MBA could not analyse it to death." In other words, fresh thinking and an open mind are needed in a growth company. Aside from the map and compass example (see page 36) another enlightening analogy to illustrate fresh thinking is to rethink the game of chess: Deep Blue beat Garri Kasparov in 1997, but only because both players were bound by a set of rules. In business, the player who is able to move his pawn from A2 to E7 in one move, beats the opponent by surprise (Nordström and Ridderstråle 1999).

But if no rules apply, and the techniques cannot be taught in school, what is it that can be done? There should be some answer, as the practice of a *besserwisser* is futile - merely pointing out the inefficiencies without suggestions for corrections leads nowhere. We will try to shed some light on the managerial needs of a fledgling company by approaching the subject from outside in. First, we examine what strategists have to say about small companies, their strategic planning and applicable strategy options. Then, we will get closer to the actual practice of management, analyzing management and leadership on a general level in small businesses. Finally, we will evaluate mentoring as a concept for transferring expertise to disposal of the emerging company.

### 2.4.1 Entrepreneurial Strategies

*"Tactics teaches the use of armed forces in the engagement; strategy, the use of engagements for the objects of the war." – Carl von Clausewitz*

**Strategy as Science and as Practice**

The etymological origin of the term strategy is in Greek, where words for army and leader – stratos and egos – were combined to *strategos* for "general", or leader of the army. Later, a *strategos* not only commanded troops but was also more or less the governor of the province, introducing management to the concept. Today, strategy is still a concept of war, but also to a very large extent a concept of business, as defined by an early business strategy scholar: “The determination of the basic long-term goals and the objectives of an enterprise, and the adoption of courses of action and the allocation of resources necessary for carrying out these goals” (Chandler 1962).

Another example of the many definitions of strategy is “the pattern of objectives, purposes and goals and major policies and plans for achieving these corporate goals, stated in such a way as to define what business the company is in or is to be in and the kind of company is or is to be” (Andrews 1971), while one quite apt and more recent definition states “the plot of the firm’s action, the string that pulls together the events” (Näsi 1991). With this broad definition, the concept of strategy comes very comprehensive, as it can be directed at a future strategy or a strategy already used. It also allows descriptive and normative examination of the strategy (ibid.).

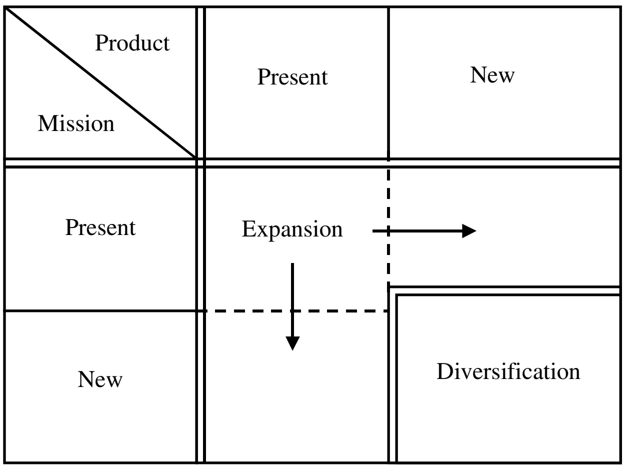


Figure 17: Product-mission matrix (Ansoff 1965)

One of the earliest contributors to applying this art of war to business and economy was Ansoff (1965), who looked at the possibilities from a strategic perspective. In his view, the most important strategic decisions boiled down to questions regarding expansion and diversification. The resulting tool, originally a product-mission matrix but nowadays better known as a product-market window, pushed companies – especially corporations – to identify their opportunities and make decisions regarding what markets to pursue and with what products.

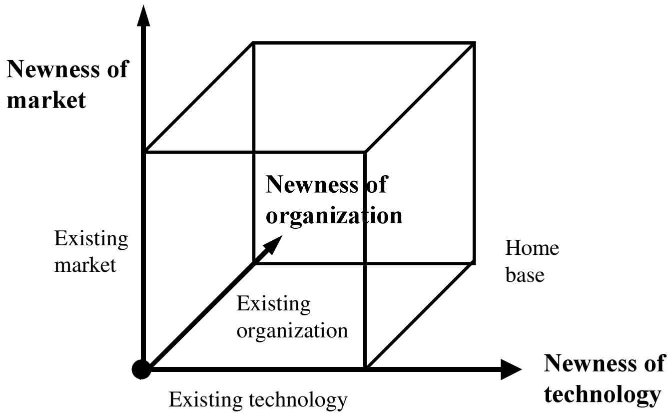


Figure 18: Learning by Moving Away from Home Base (Burgelman and Maidique 1988)

Burgelman and Maidique (1988) re-visited the subject in their book about the strategic management of technology and innovation. They noted that a company may continuously develop improved designs, variations of their earlier success products. But in time further variations are no longer profitable, and the company usually decides to depart from the original theme by adopting a new technology, by attacking a new market or by an organizational change. Changes in any of these three dimensions can result in an economic failure but also in new learning as illustrated in Figure 18. Regarding this illustration in our context we should note that a high-technology start-up is by definition taking a step towards the unknown in all three aspects, posing a major challenge to the strategic management and high risk to the company.

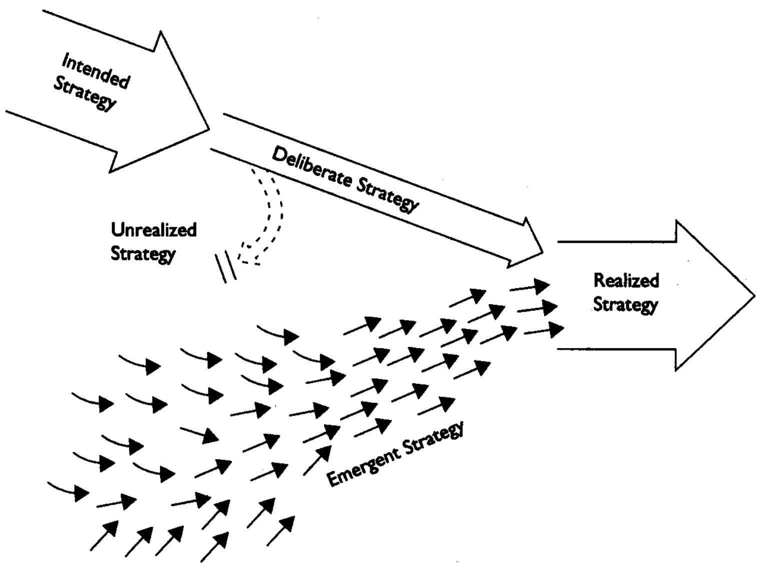


Figure 19: Forms of Strategy (Mintzberg 1994)

After early pioneers like Ansoff, Chandler and Andrews had – figuratively speaking – opened up a Pandora's box, a vast number of strategy disciplines emerged, to the extent that today a popular debate is about how many different schools of strategy thinking actually exist. The nature of business strategy as a science today is inherently targeted towards large companies and corporations. We are teaching, learning and applying business strategy for an environment which in its purest form is predictable to a certain extent; competitors known, markets researched and products ready. Even so, there are many caveats in the strategy work: environment changes and provides many surprises, calling for immediate adjustment of the corporate strategy. Hence, the realized strategy may be quite different from the intended strategy.

**Start-Up and Growth Companies as Strategy Context**

Of all the taxonomies, one of the most recent ones comes with ten categories, one of them "the entrepreneurial school" Proponents of this school see personalized leadership, based on strategic vision, as the key to organizational success. From being attached only to tightly entrepreneurial activities of creators of their own businesses, the word gradually broadened to include various forms of personalized, proactive, single-minded leadership in organizations. But even if these ideas are applicable to large organizations, they are very different from the original strategy thinking of planning, describing and prescribing. (Mintzberg et al. 1998).

"Entrepreneurial strategies" are also discussed by Drucker (1994), who presents four conceptual approaches to performing in entrepreneurial manner. These four – *Fustest with the Mostest*; *Hit Them Where They Ain't*; *Ecological Niches*; and *Changing Values and Characteristics* – also include subcategories such as *Entrepreneurial Judo* or *Speciality Skill Strategy*. Like the entrepreneurial school mentioned in the previous paragraph they are not necessarily targeted only at companies run by an entrepreneur, but companies which want to have the benefits of entrepreneurial operating models in general.

In the operating environment of a start-up company, challenges are provided by the fact that even the basics may be unknown or uncertain. Markets have not opened yet, competitors are non-existent or invisible, and there is the obvious lack of natural track record. This unavailability of historical data, uncertainty in product development and non-existence of market give little as a starting point for a traditional strategy formation process. Still, the fledgling company need a strategy which – when well implemented - will fulfil the vision. After all, it is noted that the root cause of either small business failure or poor performance is almost invariably a lack of management attention to strategic issues (Jennings and Beaver 1997).

One of the biggest challenges in NTBF's is that they have to defy many of the "laws of nature" of the business world: in the Ansoff Window presented in Figure 17 a start-up is almost by definition going to a new market with new products, which in a corporate context would mean very challenging diversification. Because of this, start-up entrepreneurs should constantly question everything as shown in the map and compass example on page 36. Komisar illustrates this way of thinking when he describes his work with the start-ups: "I synthesize, cut across the grain to think nonlinearly about strategies and businesses. I agree with the old adage that says it's all been done before; the only issue is applying those lessons in new ways to new technologies and new markets… something that rings a bell for me and permits me to see the problem differently than before, in a new light" (Smith 2001).

Indeed, the dynamic and unpredictable nature of the start-up environment requires flexibility of nature and innovative thinking; grabbing a management book does not necessarily give suitable answers. It has even been said by a renowned strategy scholar that there is no strategic planning as it cannot be planned (Mintzberg 1994). Instead, management should work in a specific direction of development instead of rigidly aiming towards a previously set goal, and concentrate on directing the actions to comply with this larger vision or "tunnel" instead of deciding upon each individual action separately (Näsi 1987).

The situation resembles that of war and the analysis made of its unpredictable nature by Clausewitz suits well in the start-up environment: “Earlier theorists aimed to equip the conduct of war with principles, rules, or even systems, and thus considered only factors that could be mathematically calculated (e.g., numerical superiority; supply; the base; interior lines). All these attempts are questionable, however, because they aim at fixed values. In war everything is uncertain and variable, intertwined with psychological forces and effects, and the product of a continuous interaction of opposites.” (Clausewitz 1976)

Using the above excerpt for business and speaking of corporations instead of earlier theorists we could use it metaphorically to shed light on the difference between the traditional strategy paradigm and that needed in NTBF’s: even if there were numerical information about the market to be conquered, and the start-up did indeed have that information available, it would probably not have enough time and skill to analyze the data and the resulting actions would not be agile enough. Therefore, the start-up strategy process has to be based on something other than firm data or track record, and lots of it is in fact based on intuition and expertise.

This is well explicated by Brown and Eisenhardt (1998), who discuss the strategic challenge of change and propose certain approaches for those who are “competing on the edge”. The main idea for our context is accepting the fact that the future of these companies is unpredictable and uncontrolled, competing inefficient and continuous, and thinking proactive and diverse. Hence, there should be an optimal amount of structure, collaboration, heritage and planning to be organized yet agile at the same time. Too much planning may trap the company in its foresight, while focusing on current operations with no planning at all makes the company vulnerable to all changes, which – after all – are inevitable.

To illustrate this approach we can look at the game played on the improvisational edge and compare two opposite approaches to the situation: *Chaos* and *Bureaucracy*. At one extreme, companies focus on being innovative and creative, ending up with a rule-breaking culture, loose structure and random communication. The good side is that this results in true excitement and creativity as well as innovative products and services. On the other side of the coin there is confusion, product delays, unrealized strategies and lost markets and positions. (ibid.)

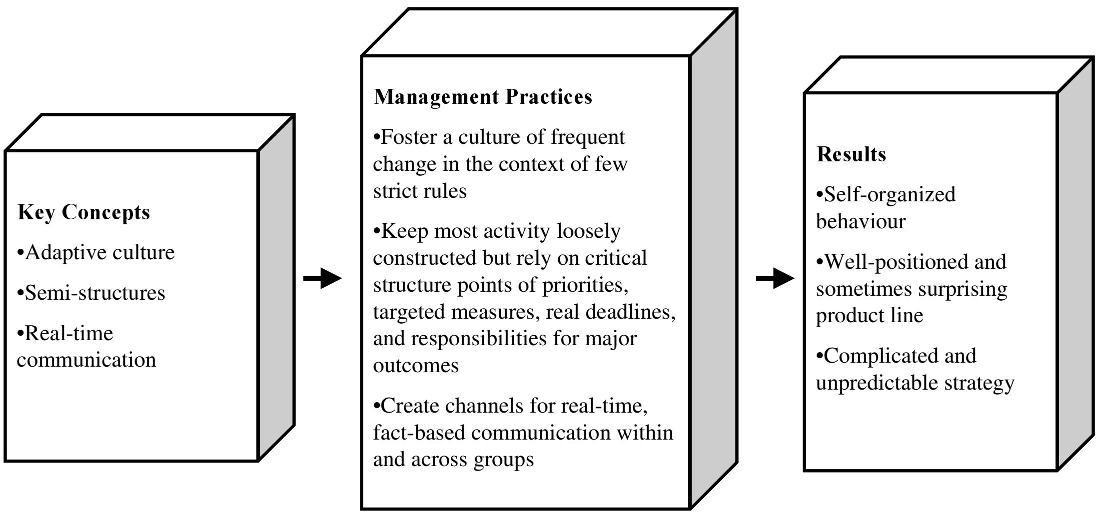


Figure 20: Navigating the Edge of Chaos (Brown and Eisenhardt 1998)

At the other extreme we have bureaucratic companies which focus on structure and processes instead of creativity. The resulting obedient culture with tight processes, rigid structure and defined communication channels provides the company wibth good process control and efficiency, but at the cost of flexibility and innovativeness. Further caveats are that the products may finally end up being wrong and the strategy is predictable. The remedy for both of these for the company is to learn to improvise and thus navigate the chaos by mixing the two extremes. (ibid.)

This is also reflected in the everyday management of the start-up company, as its leader may have to occasionally compromise or even change the strategy for agile and fluent operation of the company, relying on his gut feeling instead of calling a board meeting for advice. Applying this "business wisdom" has to be done with great care, however, and in full understanding with the owners, financiers and board. The other alternative is deliberately going in the wrong direction, which is also hard to explain at the next board meeting.

Furthermore, as noted in several places in this dissertation, the start-up company usually only gets one chance to succeed. Therefore, the two basic principles underlying all strategic planning and introduced by Clausewitz (1976) are in place: Focus and Speed. To elaborate this in his own words, one should first of all act with utmost concentration, tracing the opposition to the fewest possible sources and compressing the attack on these sources to the fewest possible actions. Secondly, one should act with utmost speed, avoiding all unnecessary detours and other expenditures of time and strength, taking the shortest possible road to the goal. Obvious as these principles may seem, their message of focus, speed and goal must not be set aside for a moment in a start-up.

**Summary**

In a new venture, as well as in one aiming for high growth in unknown areas, the strategy process must not be rigid or rely on firm data. Instead, the strategy has to be flexible and take advantage of the agility of the company. This is not to say that consistency is not important, just that an entrepreneurial company has to have a certain amount of rules and structures to support the operation but also flexibility to adapt to the changes in environment.

### 2.4.2 Leadership and Management in Growth Business

*"It's about allowing people to realize the greatness in themselves rather than demonstrating the leader's greatness." – Randy Komisar*

**Management – The Basis for Daily Work**

In early 70's Henry Mintzberg asked "what do managers do?" and conducted a study on five CEO's, comparing it with other studies conducted on managers and their work. The conclusion was that managerial work involves interpersonal roles, informational roles, and decisional roles. These roles require a number of skills: developing peer relationships, carrying out negotiations, motivating subordinates, resolving conflicts, establishing information networks and disseminating information, making decisions with little or ambiguous information, and allocating resources. He noted that this was very different from the answer managers themselves were giving when asked about what they do: in their own eyes they plan, organize, coordinate and control. These terms were introduced by Fayol as early as 1916, but even though they dominate the management vocabulary they are merely an indication of the vague objectives managers have when they work. (Mintzberg 1975)

The above example shows us the ambiguity in management as science and as practice even when both are in the context of large corporations. When going from there towards the management of smaller companies even more ambiguities rise. In a start-up company, the challenges the leader poses are often very different from those of his colleague in an established corporation. Even if the latter is about to release the fact that the red ink on results of the last quarter will end a period of 17 consecutive profitable quarters – longest in the 130 year history of the company – the worst that can happen in most cases is that he will be replaced. In the case of a start-up the question may be of life and death for the company, and for an owner-manager the effects extend to the personal side as well. Notwithstanding the fact that many generic skills are required, the management process in small firms is unique and cannot be considered to be the same as professional management in larger organizations on a reduced scale (Jennings and Beaver 1997).

The start-up leader has to be agile and persistent, yet able to cope with uncertainty and constant changes in plans and environment. Even Keynes hinted towards this in 1945 by saying that if by some mistake the US Air Force were to demolish all the factories on the North-East Coast and Lancashire with only the management inside, there would be no need to worry. On the contrary, he noted, that would in fact be the only way to achieve the status of inexperienced enthusiasm, which is the prerequisite of success (Pugh and Garratt 1993). The differing challenges of the leader are illustrated by the example of "Three CEO's" (Komisar 2001b):

According to one view, it should be noted in advance that a start-up will need three CEO's. The first one is the *Retriever*, putting together the team and starting the basic functions of the company from scratch following a clear vision in his mind. He raises the initial funding, finds the first customers and considers total uncertainty to be the spice of his life. After him, the *Bloodhound* should take over. He will sense the direction of the market and verify the concept, establishing an operative team and stabilizing the company's position in the market. His key ability is to maintain focus and make things work. Finally, when the company is about to become "established", the *Husky* should take over, leading the team and company, which is growing heavier by the day. His main characteristics are stability and scalability.

In other words, the manager or leader in an early stage company has to be personally committed and involved to the company and its success as a whole. Hence, elaborate strategic planning schemes of corporations presented e.g. by Mintzberg (1994) do not fit well as they may separate the top management too far away from the actual day-to-day operations of the company. Similarly, management techniques will have to be adjusted for the small scale of operation; a start-up manager working for instance according to the spirited concepts of the One Minute Manager (Blanchard and Johnson 1981) would soon find himself sitting alone in an ivory tower.

Drucker (1967) also stressed the importance of a committed team and managing from the front line, illustrating this by recounting what his predecessor, Harry S. Truman, said when General Eisenhower was elected President of the United States: "Poor Ike; when he was a general, he gave an order and it was carried out. Now he is going to sit in that big office and he'll give an order and not a damn thing is going to happen." In a start-up, the leader should not be a president but more like a general. To know if the food is good, he has to be there and eat the same food as his soldiers, not rely on someone else's report or on something which is brought for him to his offices. Only then does he *know* if the food is good. (Drucker 2002)

The differences between leading an entrepreneurial company or a real start-up have been extensively elaborated in *Innovation and Entrepreneurship* by Drucker (1994). According to him, implementing entrepreneurial tactics and even strategies is a success factor not only for small companies, but also for corporations and non-profit organizations. But in his case the emphasis is more on leveraging the benefits of entrepreneurship to larger organizations than vice versa. Unfortunately, even in the case of businesses led by entrepreneurial teams having substantial equity stakes in their company, the benefits wane as the company grows more mature and the growth rate falls (Ensley et al. 1997).

The actual day-to-day management of small companies is a multi-faceted challenge. A handbook written about management of high-tech companies first lists three key aspects of management - marketing, engineering and production – and then notes that each one of these has to be coordinated together with the other two, making it a multiple challenge; as if it were not challenging enough that the targets are moving. Secondly, the book brings up some other facets of management, namely financing, strategic planning and human resource management. (Riggs 1983)

Regardless of whether we look at a book or the real world around us, it appears that there is a vast number of issues in the entirety requiring management attention and decision-making; security issues, computer systems, communications, social relationships and so on. A very practical and realistic approach to this is given by Almgren and Lindfors (1996b) in the second volume of their entrepreneurial handbook, as they address issues like selecting the correct premises and preparing stationary for administrational duties to save effort later on. One can argue that none of these issues poses a significant problem, but on the other hand, all of them need attention - to be taken care of.

Evidently, lack of managerial resources is imminent if the start-up has to rest only on the shoulders of the founder or CEO, the rest of the company being engineers, as sometimes is the case in an NTBF. As noted by Teal (1996), it takes managers, not management, to create a great organization. One suggested procedure to overcome this problem is to train engineers to manage. The technical and engineering view must be represented in the councils of top management, and if they are to be effective in those councils they must gain a general management perspective. (Riggs 1983)

A perhaps more prominent solution to the problem is to gather a management team, as suggested by venture capitalists in their team-product-market mantra, and also discussed in several places in this study. Taking into account the diverse nature of activities a new or fast growing venture is facing, nobody should be deemed to be a jack-of-all-trades who can handle it all. Even the best CEO will need other team members to share the workload and take care of issues which are out of his area of expertise. Besides, in a good team people act as each other's mentors, making the sum of the team greater than just the sum of its members.

### Leadership in the Growth Venture Context

On top of managing the operational issues, another challenge for managerial staff is leadership and setting goals. The executive team is usually well aware of the goals and the entrepreneurial spirit is high. But managing all other workers is of crucial importance at all stages as well. If the goals are not set and agreed properly, the work of the individuals resembles bowling without seeing the pins, as a person will not know if he has reached his targets. Lack of time is often given as an excuse for failing to set the goals properly and managing people haphazardly, which is ironic, as salary costs usually account for 50-70% of expenses. (Blanchard and Johnson 1981)

One might think that every leader has his own style of leadership, but in a study made on 160 chief executives around the world only five distinctive approaches were identified, having focus either on *Strategy*, *People*, *Expertise*, *Controls* or *Change*. The key to success was to adopt the approach which will meet the needs of the organization and the business situation at hand, regardless if it fits the leader's personality. The worst thing to do is to be inconsistent with the approach. (Farkas and Wetlaufer 1996)

Leading a start-up can be called "Management by Chaos" as it may seem chaotic, and indeed it sometimes is. But this is a fact dictated by the environment and should be considered as a challenge, not something to be avoided or fought against. And in the best case, it can even be used as a competitive advantage: "In the tumult and uproar, the battle seems chaotic, but there must be no disorder in one's own troops. The battlefield may seem in confusion and chaos, but one's array must be in good order. That will be the proof against defeat. Apparent confusion is a product of good order; apparent cowardice, of courage; apparent weakness, of strength." (Sun Tzu 1998)

Enthusiastic leadership is not always the best approach, though, and praising visionary leadership at the expense of solid managerial work can be criticized. There are instances, however, when charismatic leadership is required, namely in entrepreneurial start-ups and during crisis situations (TenHaken 2003). When asked about the keys to entrepreneurial leadership, Komisar pointed out three things - communications and charisma; self-knowledge and humility; and something which could be described as blessed foolishness or clever insanity – as follows:

> *"Entrepreneurial leaders need to be a little bit deaf and a little bit blind. By definition they're trying to do something that defies the common view. They have to be inured to sceptics. They have to believe that their vision is true and they can make it happen. But if they are* too *deaf and* too *blind they won't learn from the market or their advisers, and as a result they won't have a chance to course-correct. They won't be able to respond and adapt as more information becomes available to them. It's a tricky balance.*
>
> *They've also got to be great communicators. They've got to be electric in sharing their energy and vision broadly among potential employees, potential partners, potential investors. That borders on charismatic. Now, there are different styles of charisma. But there has to be something compelling about the leader that inspires others to follow.*
>
> *And, whether it's a start-up or not, you need a leader with adequate self-knowledge. Lots of entrepreneurs -- especially those who experience early success -- don't understand the basis for their success and believe themselves infallible. Those entrepreneurs tend to fail the next time -- hard. Without understanding your own strengths and weaknesses, you are unlikely to create an organization with the genetics for success. Where each piece complements the rest and the whole is stronger than the parts." (Komisar 2001a)*

The first two issues – referring to communications and humility – are fairly clear concepts as such, but for the third one there is no definition at hand. In the experience of the author of this study, being suitably immune to outside advice and sufficiently deaf to the sceptics is a pre-requisite for success. For any project or venture, there are many who either say it is insane or merely suggest doing something else. The spirit of these outside spectators is that "it sounds good, but if it is clever then why is nobody else doing it already?" This phrase has probably been heard by every other inventor in the history of mankind.

The author has been involved with two companies realizing things which were supposed to be either wrong or impossible. Pirkanmaan Uusi Panimo – PUP Oy (www.pup.fi) was founded after the last surviving brewery was closed in Tampere region, threatening to break a 140-year old tradition of brewing in the region (Rasila 1984). In the prospectus for its issue of shares it promised to build a brewery, an idea which was strongly advised against by the practitioners, who pointed out that merely a bottling line would cost about €6 million. The company got the necessary share capital and built the brewery from scratch with half of this money, including a bottling line.

Another example is Sample Rate Systems, which was founded in 1993 before the concept "born global" was widely spread. At this time the standard practice for starting to export from Finland was to first get established on the domestic market, and then cautiously try out a minor operation towards Sweden, which is the neighbor of Finland. Only after reasonable experience and success from there, as the advisors said, could one even consider going further. For Sample Rate Systems this was not an option, as it had practically zero domestic demand. Its strategy was to go international from day one, which resulted in exports to 16 countries during its first year of operation. Similar stories can be told about many net-based companies, which have totally overturned the old paradigms of international marketing and global distribution.

Maybe the concept we are looking at could be called “smart luck” as Randy Komisar does, or “guided luck” as done by the present author. A key notion is that one has to expose himself or his company to strokes of luck. Assisting luck may not be always required, but the opposite – keeping it at bay – is fatal. The same thing applies to making decisions: effective people do not make too many decisions, but concentrate on the most crucial ones and try to make them so that they lead to action (Drucker 2002).

Simplified scenario of making decisions has four steps (author unknown): First, find out what the question is about and the facts about it. Then, make a decision and put it into action. Third, never look back. On the other hand, the fourth point says that if you later on find out controversial facts or it otherwise becomes clear that the decision was wrong, correct it – there is no point of being stubborn. The implicit message of this principle is clear: The most harmful decision is the decision which is not made, as it does not provide *any* chance for success, of being the correct one.

**Summary**

Managing a growth venture or building one from scratch is a challenging effort, drawing for expertise on many sectors. The battle is best fought with a good team, in which the members support and complement each other. Despite the importance of the group, there should be a leader to set and explicate the overall goals of the company. At best, the leader is capable of inspiring the team and the whole personnel to act as one, overcoming the obstacles lurking in the chaotic operating environment of the venture and eventually finding the way to success.

### 2.4.3 Mentoring as a Tool for Transferring Expertise

*"In the caterpillar’s view of the world it is impossible to fly.” – Paul Lefebvre*

**Mentoring in Principle**

The most basic – and supposedly the oldest - method of learning is by trial and error, in which one tries to achieve the goal by different means until one of the methods works. This, of course, has many drawbacks and is not applicable in all cases. Trying to find out which door leads to the restroom usually leads to success, but sampling which mushroom is poisonous is much more hazardous. A slightly more advanced method is to imitate, which is fundamental for a growing child or animal. In this case the challenge is to find someone to imitate and to imitate all the intricacies of the activity to be learned. Learning to walk is easy from an example, but trying to imitate penicillin or gunpowder is a lot more complicated.

If the information already exists, i.e. when something has been learned, the constructive way is to share the experience of which method was the usable one. For someone with first-hand experience it is easy to tell which mushroom to reject or how to make gunpowder or extract penicillin – to teach. The same applies to various other tasks as well, when a more experienced person can transfer his expertise to another by exposing it for use – sharing the knowledge. In many cases the tasks cannot be taught in a formal manner, but a more apprentice-like approach is needed. In some cases this apprenticeship can be called mentoring, with mentor seeing after a mentée or a protégé.

Besides teaching, a mentor can provide the protégé with support and advice, and mentoring can be applied in many ways and for many purposes. The US National Mentoring Partnership (www.mentoring.org) seeks for adults who would act along with parents, providing young people with the support and counsel they need, while the International Telementor Program (www.telementor.org) facilitates electronics mentoring relationships between professional adults and students worldwide. In the US, mentoring female professionals and managers as done by members of MentorNet (www.mentornet.net) has been a practice for a long time, and a host of companies have their internal mentoring programs for employees. All in all, the Mentor Directory (www.mentors.ca) lists close to one hundred different mentor organizations with a prominent web presence, including those serving teachers, MBA students or clergymen.

Closer to the focus of this study are organizations such as the Canadian Youth Business Foundation (www.cybf.ca) or the Startech Foundation (www.startech.org), which operate in business mentoring, providing less experienced entrepreneurs with more seasoned counterparts to act as their mentors in various business situations. The first of these is discussed in more detail and analyzed in Chapter 4.2.11 from page 151 on. Besides mentoring, one speaks of counseling or coaching, and in some parts of world mentors are also referred to as "godfathers", which they in a sense are (Yrityskummit 2002). For clarity's sake we narrow our approach to mentoring, even though there are sources trying to distinguish for example coaching from mentoring (Faure et al. 1999).

When defining mentoring it is traditional to refer to Mentor, the tutor of Telemachus, son of Odysseus. Webster's dictionary recognizes *Mentor* as the loyal adviser of Odysseus, to whom he trusted the care and education of his son, and *mentor* as a wise and trusted counselor. When looking at the original source we find a more colorful picture. First of all, Mentor was indeed seeing after Telemachus, but in many cases it was Pallas Athene who disguised herself to the form of Mentor to speak his wise words to those she wanted to influence. The most notable case of this was the trip Telemachus made to find out about his father's fate, accompanied by Pallas Athene as Mentor. Thus, in this case Mentor actually gets the credit for the deeds of someone else. (Homer 1985)

Furthermore, Homer says that when sailing away Odysseus left his house for Mentor to take care of. Unfortunately for everyone he was unable to keep the suitors out of the house. Despite his efforts the townspeople did not support him against the suitors, a fact which both the townspeople and probably also the slaughtered suitors regretted later. Nevertheless, the saga had a happy ending of sorts, and the reunited family of Odysseus lived long and happily with their friend, Mentor, among them. (Homer 1985, Henrikson et al. 1990)

Mentoring itself is not very clearly defined in the literature but related organizations give usable definitions for mentors and mentoring. It can be described as a supportive learning relationship between a caring individual who shares his/her knowledge, experience and wisdom with another individual who is ready and willing to benefit from this exchange to enrich his/her professional journey (Faure et al. 1999) or a partnership of learning, in which the mentor shares the experience and knowledge with protégé, to their mutual benefit (Odyssey 2003). These definitions hint at the dimension of mentoring which is new when compared to the master-apprentice relationship: bi-directionality and interaction, which requires more of both mentor and mentee (Vuorikoski 2001). The interaction is also rewarding, as those who have already "achieved" will also benefit from mentoring up-and-coming protégés (Phillips-Jones 1982).

Organizations list a wealth of benefits of mentoring for mentors and especially the mentées, who have a chance of receiving "behind-the-scenes" support and advice on technical, financial and ethical issues that will increase the chance of success, learning business strategies in a non-threatening environment, growing through greater awareness of challenges and opportunities and being introduced to other business and human resources (Odyssey 2003). On a perhaps more practical level the mentée or mentée company will get advice on request and have a sparring partner for discussions when looking at different alternatives (Kivimäki 2002).

Conversely, mentors will get exposure to new and different thinking styles, help to develop future leaders, hone their own leadership skill, get personal satisfaction and have occasion to reflect on important issues, both personal and organizational (Faure et al. 1999). Another list of benefits for mentors includes positive influence over another individual by sharing skills, values and experiences; enjoying the satisfaction of seeing others succeed; making productive use of one's own knowledge; upgrading one's own technical, communicative and leadership skills; expanding one's own professional network through interaction with other mentors; revitalizing interest in one's own work through a connection to young entrepreneurs and their energy and boosting one's own self-esteem through recognition from the protégé, peers and community (Odyssey 2003). Looking at these "rewards" it is evident that the mentors are not doing this for money but for personal satisfaction and possibly recognition as well.

This is natural, as the mentors are by definition experienced and therefore presumably advanced in their careers to a point where money is no longer the prime incentive. And mentoring, again by definition, is a sort of company building bee done for free (Faure et al. 1999, Kivimäki 2002). Other qualities required of the mentor besides experience include being permissive rather than authoritarian; well informed and analytical; committed to training and development; a good communicator in both directions; knowledgeable about the organization and the value of action learning; able to apply theory to practice; well organized and willing to devote time to mentoring (Kram 1986).

There are also benefits for the organization – such as access to expertise at low cost and getting exposure to a larger business network – and community - such as better use of resources and fewer failed companies. A very encouraging example of this last effect comes from the UK, where introducing mentoring to the Prince's Youth Business Trust raised the success rate from 40% to 75% for the companies supported by the PYBT in three years (Canadian… 2003).

Despite all its good qualities mentoring has limitations, too. One notion often seen in writing on mentoring is trust and confidentiality. Indeed, The mentée has to be able to trust the mentor completely before the relationship can work. Another very important factor is commitment; the parties have to agree that the relationship will last over a considerable period of time. Mutual trust, respect and good chemistry are critical to a successful relationship. (Kivimäki 2002, Faure et al. 1999)

Commitment, trust and genuine interest seem also to be the issue in an article giving examples of lack of each of these. First, a mentor gave up after three weeks as his motive was to get a mention of it on his resumé. Second, a mentée tried to steal the job of his mentor. And third, in the US Army the senior officers no longer feel that mentoring is their responsibility. Furthermore, about 90% of formal mentoring programs in corporations are eventually abandoned because of bad matching and bad follow-up. (Zaslow 2003) Hence, building successful mentoring programs is challenging.

**Mentoring Organizations**

As an example of mentoring organizations we can have a look at Finland, which is a fairly small market and does not have too many organizations to overlap each other. First, the national association of mentors *Yrityskummit* referring themselves as "godfathers of companies" has three kinds of members: close to 400 individuals, more than a third of townships of the country and number of other affiliates. There is a strong local aspect in their operation, trying to activate rural areas e.g. by encouraging executives with summer homes in remote towns and villages to serve as godfathers for emerging businesses. It appears natural that this organization was initiated and is still hosted by the public sector. (Yrityskummit 2002)

On the other hand, a local operative in Finland, *Pirkanmaan Yrityskummit*, is centered around Tampere, the biggest city in the country outside the metropolitan area of Helsinki. It has 90 "godfathers" available and they currently work in 70 companies. The appointed mentors get their expenses paid by the mentée company, and consultants acting as mentors can make a separate contract about consultant work to be done on top of the mentoring by mutual agreement. According to their chief executive, Kari Kivimäki, the activity level is high, and the mentors are regarded as "spiritual business angels".

On top of these there are private organs offering their members to board directors such as Hallituspartnerit and Nestor Partners. These organizations are closed and new members are accepted only by invitation. Nestor Partners (www.kolumbus.fi/nestor-partner/index.html) lists a number of other uses for their members besides board membership, including advisory functions in privatisation, strategic management, internationalisation or reorganization, and according to the CV's available on their website the 51 members have a good combined capacity of mastering many trades and situations. Hallituspartnerit (www.hallituspartnerit.com) is a recently formed association of 13 members, and they note that an experienced board member has many advantages over the use of family members on the board - objectivity, expertise - or consultants in general - low cost, length of time span, continuous availability (Tampereen… 2003). Despite many common elements these cannot be regarded as genuine mentoring organizations since they are closed and the members require monetary or other compensation for their efforts. Thus, they are closer to advisors than mentors.

The models of mentoring organizations in Finland described above are by no means unique and similar or resembling entities exist in many countries. Also, there are many organizations introducing new methods of mentoring or advice and consulting on mentoring itself – sort of meta-mentoring. The following examples illustrate the multitude of these modern incarnations of mentoring institutions:

- On-line mentoring association Score (www.score.org), which offers free "Counselors for America's Small Business" either face-to-face or by email
- Business Round Table (www.businessroundtable.ca), organizing peer group meetings of about ten people, where the participants act as a Personal Board of Directors for each other
- Business Mentoring Academy (http://www.business-mentor.org/), educating mentors and giving them the chance to reflect their experiences with other mentors
- Yellowbrick (http://www.deliverthepromise.com/) provides consulting for organizations wishing to design and implement their own mentoring or coaching programs, offering seminars and guidebooks on the side

**Challenges in Mentoring**

Overcoming the issues of trust and commitment and finding compatible pairs is the key challenge in successful mentoring. The mentée has to be trustworthy so that the mentor can feel safe, and open in order to utilize the potential of the mentoring relationship to the full. The mentor likewise has to be trustworthy for the same reasons, and committed to a longer relationship. Therefore, the motives of the mentor should be clarified at the outset, at the same time when the compatibility of personal chemistries is verified.

Further challenges for mentoring are brought up by "new mentoring relationship rules" as illustrated by Phillips-Jones (2001):

- Mentors have developed expectations which are more defined and stringent, and demand for mentoring has soared. It is thus common for executives to lay down rules before entering into a mentoring relationship in order to save time and energy, focus on the essential and avoid guilt when unable to help.
- Compared to decades-long relationships of the past, mentoring relationships of today may be just months or even weeks long and often highly focused on certain pragmatic issues. Currently introduced pairs seldom expect to work together for years.
- Mentors can be of any age, and the mentées of today are more willing to take advice and help from anyone possessing the required experience and influence, regardless of age or gender.

Although the foregoing is principally applicable to corporate mentoring schemes, it adapts well to business mentoring as well. Another contemporary aspect of mentoring is the so-called leadership gap, emerging from the need for senior management growing 20-30 per cent annually. Additional factors contributing to this gap are considered to be the abandonment of traditional leadership tools in the 90's and mergers and consolidations resulting in diminishing numbers of middle-management posts. Mentoring is considered to be a promising tool for crossing the leadership gap. (Schweitzer and Dolan 2001)

**Summary**

Some of the features and alledged benefits of mentoring sound very reasonable and well grounded, for the very thing inexperienced fledgling entrepreneurs and their start-up companies lack is self-evidently and by definition experience. They should not be pushed to make the same mistakes someone else has made already, if this someone has learned from the experience and can forward the experience to newcomers. Furthermore, the pace of development is accelerating, and the new entrepreneurs do not have time for learning-by-doing or the inevitable mistakes ensuing. Only few companies can afford consultants to guide their path, however, and even good consultants may lack the experience of the most experienced business mentors. In this sense the best mentors would therefore be other entrepreneurs and experienced businesspeople.

## 2.5 Ownership

*"The landscape should belong to the people who see it all the time." - Le Roi Jones*

Principally, *ownership* is a state where something belongs to a person or an entity, who therefore has the legal right of possession and proprietorship over the subject in question (Webster's… 1989). Proprietorship, according to Webster, refers to exclusive control. My house is mine to live in, and my car is mine to drive. Both control and ownership can be shared or limited, as for instance driving a car under-aged or as fast as it can run is usually illegal. Owning another person or a box of hand grenades would not be only illegal but also unethical by modern standards. But in general, one's property is his to use and control, be it a house, a car or a company.

Historically, companies have been controlled by their owners. This also applied to corporations, but as ownership became dispersed, owner control was diluted. Furthermore, as the corporations grew large, their economic actions came to have increasing social consequences. Effectively, the giant corporations ultimately went under the control of their management, and the concept of social responsibility arose to provide them with legitimacy for their actions. (Mintzberg 1989)

This separation of control and ownership was noted with concern already 1776 by Adam Smith, who said that when ownership and control of corporations are not fully coincident, there is a potential for conflicts of interests between the owners and the controllers. In his view, the shareholder corporation was a vehicle to gradually separate the owners from control of their own property. (Smith 1875) Yet, since the structure – separation of ownership and control - has survived all these years it must possess benefits which more than compensate for its drawbacks. *Agency theory* introduces one model to approach this issue by defining the owners as principals and those who control as agents. The goal in its context is to define the best contract between these parties to minimize the agency costs. By the laws of nature, some agency costs nevertheless remain.

Another factor hindering optimal performance is conflicts of interests. To reduce their detrimental effect, *corporate governance* mechanisms are put in place, “setting rules on how management of a company is directed and controlled in order to maximize the profitability and long-term value of the firm for shareholders while taking into account the interests of other legitimate *stakeholders*” as defined by the World Bank (Haapanen et al. 2002). An explicit element in governance mechanisms is *board work*: the main function of a board of directors is to represent the shareholders’ interests and to see that management is working for the benefit of the company, and therefore the owners.

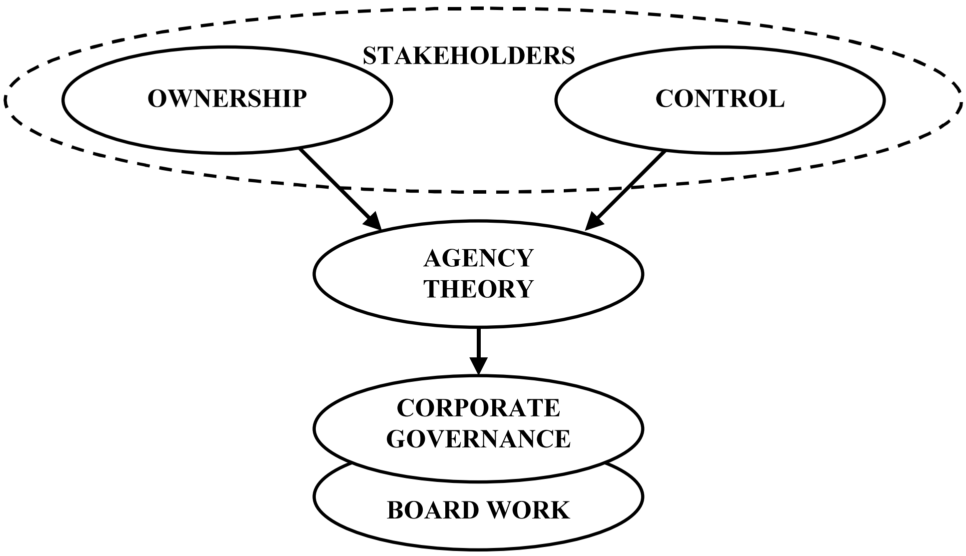


Figure 21: Theoretical Framework of Ownership

All these elements together form the theoretical framework centering on or stemming from ownership, as presented in the above figure: The shift of control from owners to managers, creating tension between these stakeholder groups; agency theory trying to model this and corporate governance, aiming to minimize the harmful effects by a set of tools, including the board work. All these elements are examined separately in the following.

## 2.5.1 Passive and Active Ownership

An unlisted, private company is normally owned by people who have some kind of interest in it. They have founded the company, run it or have invested in it during its risky early days. The investor may for instance be a relative or a business angel, and even though not involved in the daily operations wants to be kept informed about the status of the company. On the other hand, in a public company the ownership is widely dispersed and therefore the interest in the company is also spread: the active owners have become passive investors, who watch others run the company and have little power over the operation. Sometimes the investors find out that management has misused their money and trust, resulting in bankruptcy and lost of invested monies – in these cases a more active involvement from the owners would have been appropriate.

Veranen (1987, 1988) discusses this in his work on relationship between the ownership function and the performance of the firm. His findings suggest that if there is insufficient organizational learning, a misfit between the business idea and the changed industry logic will occur, resulting in decreasing performance and management confusion. At some point, the owners will become alarmed, making their own diagnosis on the situation and searching for alternatives, as ownership-level decisions are evidently needed to set things right. In many cases this means that the company mission and role have to be revised.

Managing ownership is not always easy, however, and may even be regarded as a profession of its own as noted by Seppä (1996, 2000). The first management profession was corporate management, the development of which started from Adam Smith's (1875) Wealth of Nations, originally published in 1776 at the dawn of the industrial revolution. Given time, the separation of ownership and control led to a managerial revolution and resulted in the birth of the investment management profession, as described in 1933 by Berle and Means. The latest revolution in this development is the shareholder revolution, which made room for the ownership management as a profession. One starting point for this can be considered the works of Jensen, who discussed the leveraged buy-out as a tool to regain owner control in large corporation. (Seppä 2000)

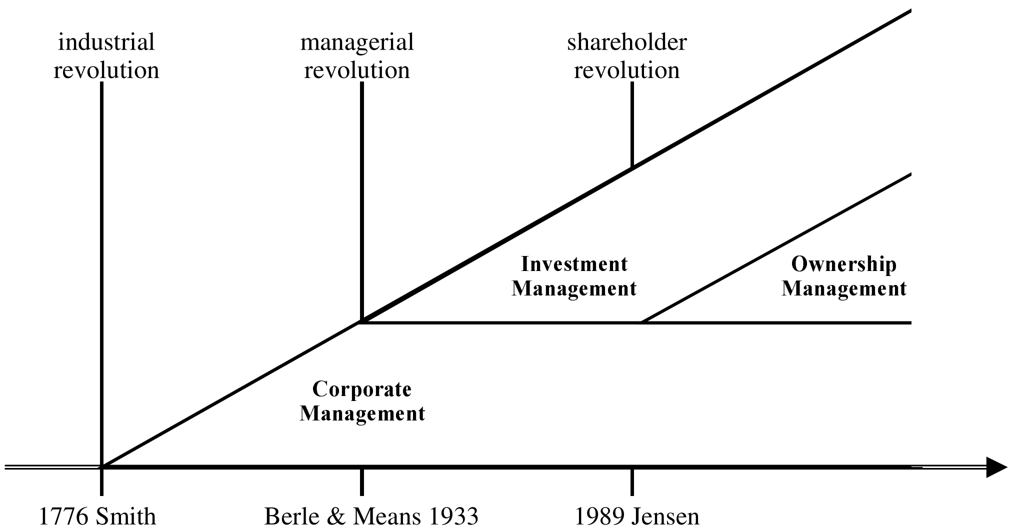


Figure 22: Divergence of Management Professions (Seppä 2000)

In our context we should consider the preferred owners of small companies to be active actors: individuals and entities with a genuine interest in the well-being of the company, the will to participate in overseeing the company and changes to bring added value to the table. This added value ownership was defined by Veranen (1996) to require several things:

- The ownership structure allows guidance by owners
- The owners are able to contribute expertise in addition to capital
- The company implements an appropriate model of administration
- The board is able to bring added value and implement risk control

- The mechanisms for control and reward are in line with owner's interests

Owner-managers and other shareholders working full-time for the company are most certainly motivated and committed, and add value every day with their work. The possibilities of a relative who put some seed money in may have more limited prospects and interest to add value, while a venture capitalist usually is both interested and capable of having an active role through e.g. board work and networking.

Reflecting on the earlier discussion about financing, we note that between the friendly money and venture capital there are also other sources of private equity financing. Business angels act as informal venture capital providers, and in many cases take an active role in the companies they invest in a similar manner as the venture capitalists do, except that in his case he is managing his own ownership, while the venture capitalist is acting as an agent for someone else – a dilemma which will be discussed more thoroughly in Chapter 2.5.2 regarding agency theory.

Still, both of the actors mentioned above have a common goal, which is fairly well in line with the benefit of the company as well: shareholder value through growth in valuation of the company. But a corporate venture capitalist may have a more contradictory ownership position. In many cases, he is not aiming to maximize the direct returns but focusing his attention on companies with the most strategic value to the financing corporation. Hence, corporate venture capital may be used as a corporate strategic tool. (Seppä et al. 1992)

To a certain extent, another similar force which may detract from the benefits of other shareholders is ownership by outside blockholders. Typically, a corporation has very dispersed ownership and the small shareholders have little or no interest in and means of taking part in the decision-making. On the other hand, those with a more significant ownership position have more incentive and means to monitor and influence the managers, exercising control over them. This in the best case works for the other shareholders as well, maximising the general wealth. But in the worst case, the blockholder may also utilize the private benefits of control and extract corporate resources, thus reducing the value of the firm for the other shareholders. (Denis and McConnell 2003)

This effect may also work the other way around, as managers holding substantial equity stakes may entrench themselves and want to resist the power of other owners. This is in a way counterintuitive, as it would be reasonable to assume that a greater overlap between ownership and control would lead to a reduction of conflicts of interest, thus raising the firm's value. It is not so simple, though, as to the extent that the shareholders' and managers' interests are not fully aligned, higher equity ownership may provide the managers with more freedom to pursue their own ends without fear of reprisal, entrenching the managers. Hence, the ultimate effect of managerial ownership is a trade-off between the alignment and entrenchment effects. (ibid.)

Regarding these controversial or problematic situations between management and owners, altogether six distinct "syndromes" were identified by Veranen (1987, 1988): The abdicating owner syndrome; the inheritance syndrome; the co-operative syndrome; the state-owned company syndrome; the joint venture syndrome; and the emergent joint-stock company syndrome. In all these situations the performance of the company is impaired but the ownership-level intervention with positive consequences is not triggered due to a variety of reasons. The result is that the ownership becomes first indifferent and then starts labilizing the company, as the owners or their representatives finally have a negative impact on firm performance until corrective measures are made.

Dividing ownership among the managers and other active participants is often advisable, however, as even a minor equity ownership makes the workers much more committed to the success of the company, unleashing their full potential. An extreme example of this is the spirited concept of Gross (1998) called the "new math of ownership", based on the assumption that potential for financial gain only partially explains why equity motivates employees. Rather, once they have food and shelter, the rest is about fulfilling their fantasies. According to Gross, equity is a good tool for harnessing the power of fantasy with the protagonist being the company, competition the antagonist, and a full story with struggle, victor and hero. Therefore, all economic endeavors should be broken down to tribes of one hundred people or less to make people feel the story is theirs.

All in all, ownership of a start-up or small company is an interesting topic for discussion. The founder may be keen on keeping full control over his property, but only sharing it with others will make them genuinely interested in the well-being of the company – commitment, responsibility and incentive go hand in hand. On the other hand, giving too much ownership to outsiders or managers may make them strong and hence able to pursue their own goals, consequently compromising the benefit of the company. A balanced ownership structure appropriate to the overall situation of the company is the best, albeit a volatile alternative. Important factors in maintaining the balance of the counterparts is also to take into account the agency issues and various agendas of different stakeholders, and to have appropriate governance mechanisms in place. These issues will be discussed next.

### 2.5.2 Stakeholders as Actors in the Small Firm Environment

**The Stakeholder Theory**

A stakeholder is any group or individual, affecting or affected by an organization: suppliers, customers, employees, financiers and communities, or by a wider definition also political groups, government, media and so on. Stakeholder theory proposes that managers of firms have obligations to these groups of stakeholders. It is often juxtaposed with stockholder theory (a.k.a. shareholder theory), ironically suggesting that the firms may well have broader obligations than traditional economic theory has assumed. (Werhane and Freeman 1997) On the other hand, it is admitted that recent scandals hint at failure of the shareholder theory, suggesting that the duty of a manager is not simply to maximize shareholder returns but to balance the shareholders' financial interests against the interests of other stakeholders who are also risk bearers in the company, either voluntarily or involuntarily (Smith 2003).

The basis for the problem and the consecutive development of stakeholder thinking can be traced back all the way to the Age of Enlightenment, when Adam Smith articulated the rules for free enterprise (Wheeler and Sillanpää 1997). Notions of stakeholderism can be found in the works of organizational theorists and other theorists throughout the $20^{th}$ century, until the word *Stakeholder* finally first appeared in management literature in an internal memorandum at the Stanford Research Institute in 1963, who defined it as "those groups without whose support the organization would cease to exist" (Näsi 1995, Donaldson and Preston 1995). Yet, the originator of stakeholder thinking as we know it today is Eric Rhenman (1964), whose work was the basis for stakeholder thinking becoming one of the cornerstones of industrial democracy in Scandinavian. The Swedish term he used, "intressent", translates as *interested party* or *concerned party* and was translated into Finnish some years later as "sidosryhmä", meaning *interest group* or *binding group* (Ahlstedt and Jahnukainen 1971).

The global breakthrough of stakeholder thinking began in 1984 from the works of Freeman (1984). At the same time the core idea had already established its position in Scandinavia – as an example of this we can note a handbook written for managers on the management of interest groups – employees, workers' unions, society, customers, and so on – and explicitly discussing corporate democracy and ethics (Heiskanen 1984).

Hence, stakeholder theory is fairly new. As it is applied to various areas from finance to organization theory and strategic management to ethics (Werhane and Freeman 1997) it is easy to understand that there is not just one clearly expressed definition of the theory. It is a multi-faceted concept, subsuming several approaches within one theory. A commonly seen classification presents four approaches which differ regarding their reasoning why stakeholders should be taken into account (moral/efficiency argument), what the firm is and so on. This classification is illustrated in the figure below. (Matikainen 1994)

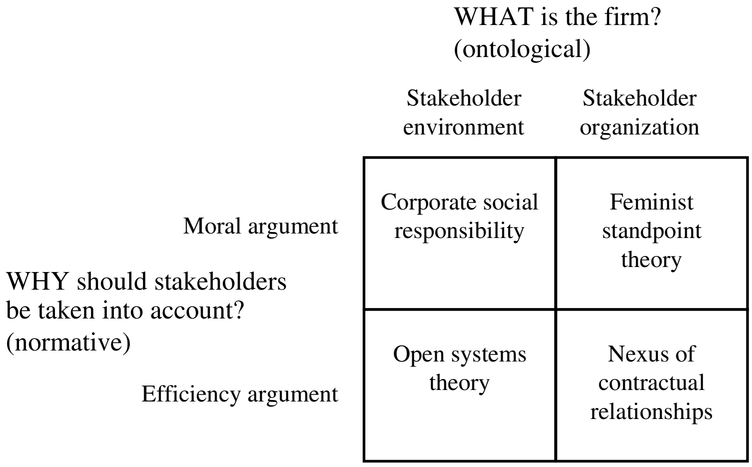


Figure 23: Classification of Approaches in Stakeholder Theory

Another more recent and very practical classification identified three contrasting approaches. First, we could think of stakeholder theory as an instrumental theory, assuming that since the managers want to maximize the objective function of their companies and hence must take stakeholder interests into account. Second, the descriptive approach wants to describe how managers, firms and stakeholders in fact interact. Third, there is a normative sense of stakeholder theory that prescribes what managers ought to do. (Donaldson and Preston 1995)

On top of these three uses for the theory, Freeman, originator of stakeholder thinking in the US, has also suggested a fourth use of it: metaphorical, depicting the idea as a figure in a broader narrative about corporate life. He also argued that the efforts at finding a full-blown stakeholder theory to replace the stockholder theory are in vain. To explain this argument the *Separation Thesis* was presented - a hypothesis stating that the discourses of ethics and business can be separated so that sentences like "X is a business decision" have no moral content and vice versa. The question is whether or not this thesis is valid. (Freeman 1995) Efforts are being made towards a unified stakeholder theory, such as the *Convergent Stakeholder Theory* combining the social science approach and normative ethics approach (Jones and Wicks 1999).

This leads stakeholderism towards business ethics and moral issues, where the debate has nowadays migrated from corporate democracy and strategic management. Books have been written applying the stakeholder approach to the ethical management of companies, based on the idea that business and moral are inseparable. According to Freeman (1994), the stakeholder concept can be used to create more fine-grained analyses that combine both business and ethics. To take this thought further, we can use the stakeholder approach to also combine ownership and ethics. The idea of a moral community or of a moral discourse cannot be divorced from the idea of the value-creation activity of business.

Following a similar path, Langtry (2002) discusses responsible ownership when viewing the ethics of shareholding. His main conclusion was that it is morally wrong to buy shares in a company that is behaving badly unless one is willing and able to prevent the misbehavior. An important factor here is the level or kind of authorization, which he describes in very much the same manner as agency theory does, also considering the roles of mechanisms made for corporate governance such as board of directors. In a small business, this would mean that it is unethical to own a company which is doing wrong. Furthermore, we could conclude from the above that the managers, acting on the owner's behalf, need to be properly authorized and that the owners need to have an active interest in the business of the company and the manner in which it is conducted.

After all, as expressed by Langtry (2002): "Neither a company nor a self-employed plumber doing jobs for households can justify unfair, malevolent or callous conduct merely by saying that it promotes profits". During the years, the myth about business being amoral, outside all moral discussion has weakened, especially in developed countries. At the same time moral is no longer considered to be a strictly personal issue either, and people's opinion about child labor and ecological issues is forcing companies to react and eventually comply. Companies and their leaders are gradually adopting the notion that there is more to the role of a corporation than just maximizing the profits for shareholders. (Kujala and Kuvaja 2002)

Yet the stakeholder approach has also received criticism. Mintzberg (1994) saw it as merely another step in a long row of different activities called planning. Seeing that stakeholder analysis is a tool for implementing "planned policies" he argues that this effort of calculating and factoring the wants and needs of all influencer groups into the planning process in a way which would pave over all the messy affairs of power and politics is in vain. Boldly, looking at the issue from the management point of view, he questions whether implementing the stakeholder approach does more than encourage unnecessary political conflict and then lose it by fighting fire with frivolity.

**Stakeholderism in Small Business Environment**

In the small business context, studies on stakeholder theory are scarce but not non-existent. Nevertheless, small businesses must interact with stakeholders similar to those of corporations. Different stakeholders have different stakes and powers, which vary over time depending on the situation the company is in. (Huse 1995) When stakeholder involvement has been measured in small companies evidence has been found supporting theoretical models predicting greater involvement during external turbulence. Somewhat surprisingly, however, the age of the firm, industrial classification or perceived business conditions did not play a significant part in determining the level of involvement. (Atkins and Lowe 1994) One particularly interesting notion is the status of an owner-manager regarding the stakeholder concept. It has been noted that the multiplicity of roles expected from an owner-manager as the principal stakeholder often causes dissonance, which may lead to poor decision-making and inappropriate action (Jennings and Beaver 1997).

It has even been argued that the ability to manage and develop a network of interdependent relationships with a wide and diverse range of stakeholders is a critical issue pertaining to the success of a small firm (Gibb 1997). This seems plausible, since a small company which does not pay attention to the needs of its key stakeholder groups such as customers and clients certainly will not survive long. And these relationships work the other way around as well; hence the interdependency. Building interdependency with stakeholders is likely to offer the small firm a competitive advantage though the shared subjective knowledge and experimental learning unique to the relationship developed. To fully utilize the potential of these aspects in small firm success, the owners and managers need specific competencies when initiating and developing such relationships. (Hannon et al. 2000)

In this study we are interested in stakeholder theory in a wider context, comparing it against other aspects of ownership. In a combined stakeholder-agency theory Hill and Jones (1992) reflect the implicit and explicit contracts - as in agency theory discussed more thoroughly in a chapter devoted to it - between management and stakeholders. They accept the notion of efficient markets from agency theory, but note that there are power differentials between managers and stakeholders. Some of the strategies pursued by the managers with respect to stakeholders can be seen as attempts to exploit and entrench these power differentials. In turn, new incentive structures and institutional mechanisms for monitoring and enforcing the contractual relationships between managers and stakeholders can be seen as long-run market-generated responses to disequilibrium conditions and unequal resource dependencies.

These contracts were also discussed by Huse (1995), who evaluated the role of the board as the institutional enforcer of the contracts between an owner/manager and the other stakeholders in a small firm, which can be regarded as one of the main factors of corporate governance. The success of the enforcement mechanism depended on the credibility of various actors, and those lacking credibility were ignored. According to his observations, the higher the stakes and the higher the power of external stakeholders, the higher the power of board was as it is the stakeholders who empower the board. Trust and integrity were also important in empowering the board.

As we can summarize, the company cannot think of itself as an independent entity separate from the outside world. It is part of its environment, and there are many who are interested in it and – as the definition states – without whom the company would cease to exist. These stakeholders and their interests have to be taken into account in the decision-making and operation of the company, and according to the stakeholder approach it is the stakeholders in general who empower the management and board to run the company in the first place. These implicit and explicit contractual relationships between the firm and its stakeholders lead to the topic of agency theory.

### 2.5.3 Agency Theory as a Framework for Ownership and Control

The Agency Theory

Agency theory focuses on the relationship in which one or more persons, the Principal or Principals, engage another person to perform work on their behalf, as an Agent (Relander et al. 1994). This relationship is epitomized by the Contract, which principally specifies the rights and performance criteria of the agent. The focus of the theory is in defining the most efficient contract to govern the relationship between the agent and the principal, in this case minimizing the costs of outside equity to the modern corporation. (Jensen and Meckling 1976) The theory has been applied to many contexts, including accounting, economics, finance, marketing, political science, organizational behavior and sociology (Eisenhardt 1989) and it is seen to be applicable to both large and small corporations as well as other organizations, such as large professional partnerships, financial mutuals and non-profit organizations (Fama and Jensen 1983b).

According to the literature, both principal and agent are assumed to be rational wealth maximizers, limited by the rights and responsibilities laid down in the contract. However, contracts are not written or enforced without cost, resulting in agency problems (Fama and Jensen 1983a). Problems may arise in at least three aspects. First, the two parties may have different attitudes towards risk. Secondly, the goals may be disparate, be they explicit or hidden. Finally, monitoring the agent may be expensive or difficult for the principal. (Relander et al. 1994) Sometimes the two latter problems are considered to be one (Eisenhardt 1989), as monitoring the agent and verifying his doings is not an issue if goals are equal.

It is easy to illustrate these previously mentioned so-called agency problems with real world examples in our context of entrepreneur and venture capitalist. First, the entrepreneur may wish to engage in a project which does seem too risky from the venture capitalist perspective, or conversely the VC may push the entrepreneur to take risks against his will. As an example of the second issue – disparate goals - we could think of the situation where the VC wants to invest heavily to maximize growth at any cost with IPO as the ultimate goal, while the entrepreneur would like to grow at a more modest pace and look for a safe haven through a trade sale.

The third problem – the cost of monitoring the agent - is probably known to every venture capitalist wanting to stay close with the target company but due to distance and lack of time having to be content with reports in the monthly meeting supported by an occasional phone call. The same problem also exists in large corporations, and from the agency theory point-of-view the very function of the board of directors is to be an information system for stockholders for monitoring the opportunism of top executives [9] (Fama and Jensen 1983b). In fact, it has been noted that the costs incurred by full enforcement of the contract may exceed the benefits, resulting in residual loss (Fama and Jensen 1983a).

**Implications for the Small Business Environment**

The last issue mentioned above may be emphatic in small companies because the level of asymmetric information tends to be higher in them: the entrepreneur knows more than the outside investor. Therefore, the entrepreneur - the agent – has the capacity and by definition also the incentive to take action detrimental to the interest of the principal in order to maximize his own wealth. (Barnea et al. 1981) It is fairly easy to hide – or even manipulate – information in a small company, although it is also done in larger companies, as can be seen from numerous recent examples, some of which are discussed in Chapter 2.5.4.

An interesting dilemma concerning venture capitalists makes the agency theory even more intriguing in our context. It is clear that investors, such as business angels and venture capitalists, act as principals in the investor/entrepreneur relationship. Business angels invest their own money and thus the principal/agent relationship is simple and direct. On the other hand, a venture capitalist – or the VC company - is at the same time an agent for its own investors and the principal for the target company and the entrepreneur. Because of the size of the funds they must raise and the complexity of their agency relationships, VC's tend to adopt different and more restrictive investment practices than business angels, who are less accountable to outside parties. (Van Osnabrugge and Robinson 2000) This phenomenon has been called the "double-loop agency relationship" (Relander et al. 1994).

For obvious reasons, this controversy has to be taken into consideration when assessing the strategy logic of the venture capitalists (Seppä 2000) as they tend to fund larger and more mature deals, conduct more rigorous due diligence, use more comprehensive contracts, focus on strategic rather

[9] For a more elaborate discussion on board work see Chapter 2.5.5.

than more active hands-on monitoring and put emphasis on exit strategy and rate of return (Van Osnabrugge and Robinson 2000). When pondering upon the relationship between the venture capitalist as principal and the entrepreneur as the agent, we note that they both have to trust each other. Yet, as noted in several contexts in this study, many entrepreneurs have doubts about letting an investor take part of the control of their company. Potential businesses may be suspicious of losing control over their idea and, accordingly, lack confidence in the venture capitalist, i.e. the principal. The result is that many entrepreneurs do not find the prospect of VC funding particularly attractive. (Harding 2002)

In summary, the overall stakeholders of the company have limited chances to monitor the company, as it is managed by a set group of people on a contractual basis. Goal conflicts and other potential disputes between the stakeholder groups call for mechanisms allowing them to monitor the operation of the company in a controlled and cost-efficient manner, thus avoiding risks on the one hand and adding value on the other. One explicit way of realizing this is board work, which is an important part of the whole corporate governance but only available to a very limited number of participants, who therefore act as agents of the other stakeholders.

### 2.5.4 Corporate Governance – an Articulated Form of Ownership Management

As noted in the introduction of this chapter, corporate governance refers to "the rules and incentives by which management of a company is directed and controlled so as to maximize the profitability and long-term value of the firm for shareholders while taking into account the interests of other legitimate stakeholders". This definition draws on agency theory, stakeholderism, management and ownership, and has notions from strategy and legal science. Another, briefer definition says that "if management is running the business, governance is about seeing that it is run properly". Many other definitions exist, usually including aspects of ownership, administration and control, and the concept has proven quite complex. (Haapanen et al. 2002) But to put it in simple layman terms, corporate governance is about keeping the base clean and seeing to it that rules of good housekeeping are respected.

Corporate governance as a researched phenomenon started in practice when Jensen and Mecklin (1976) published their idea about separation of control leading to agency costs of outside equity in a modern corporation. After that, research of governance mostly concentrated in the United States, where at the same time an unprecedented amount of mergers and acquisitions took place (Haapanen et al. 2002). By the early 1990's, however, research also began to appear from other countries, first from other major world economies such as Japan, Germany and the UK. More recently, the research has extended to other, both developed and emerging economies and international aspects of governance as well. (Denis and McConnell 2003) This development appears to be interlinked with the development of ownership function and change in prevalent ownership structures in these countries as discussed by Veranen (1996).

Traditionally, corporate governance is perceived as a phenomenon concentrating around public corporations, which have scattered ownership and separate ownership and management. Owners by default do not take part in management, which is done by hired professionals. Ownership of such companies is liquid and risks are divided among the multiple owners. There is much less interest and research in small companies, such as new technology-based firms or family companies, although their governance issues also merit attention. Their special characteristics should be taken into consideration when designing governance mechanisms for small businesses. (Mustakallio 2002)

**Principles and Practices of Governance in Economies Around the World**

In the prevailing US model, the basic governance mechanisms can be divided into two groups; internal and external. The first of the internal mechanisms is the *board of directors*, which is specifically charged with representing the interests of shareholders; its duties and responsibilities, rules of legal incapacities and so on. The other internal mechanism is the *ownership structure*; how the ownership and control of a firm are separated, and the equity holders and their respective shares in the company. The external mechanisms consist of the *takeover market* – if internal controls fail, the company may become undervalued and is at risk of being taken over - and *legal system* - varying greatly from nation to nation. (Denis and McConnell 2003)

So far, more than 30 countries have drawn up principles for corporate governance (Haapanen et al. 2002). Certain recent occurrences have given a major push towards refining and further development of corporate governance culture and practices. Enron, once a minor energy company rose to be the seventh biggest company in the US by 2000, when its financial engineering practices which were approved if not suggested by a leading auditing company, Arthur Andersen, were exposed, leading to bankruptcy within a month (Haapanen et al. 2002). WorldCom not only capitalized $3.9 billion to show profit in the first quarter of 2002, but also gave a so-called "sweetheart" loan of $408 million to its CEO, Graig Ebbers, so that he could buy company stock. When these actions were revealed, WorldCom quickly turned from the second biggest long-distance carrier to the largest corporate bankruptcy in the history of the United States, exceeding even Enron in size (Boyd 2003).

In the old world, after merging the Swedish Asea and the Swiss BBC Brown Boveri to form the the highly successful ABB in 1986, Percy Barnevik turned into a Chairman of the Board and gave his CEO post to Göran Lindahl in 1996. When pondering the losses of SEK 7 billion of the next year, the meeting of shareholders learned that the two by then ex-leaders of the company had a pension package worth SEK 1.4 billion, previously unknown to the stockholders and practically unknown to the board as well (Haapanen et al. 2002). Vivendi of France, Sonera in Finland or Tyco of the US would provide further examples but the point has already been made.

As for the further development, President Bush outlined a plan in March 2003 to improve corporate responsibility and protect shareholder rights with three core principles: Quality and availability of information; accountability of the CEO and other executives; and highly ethical and professional auditing (Zandstra 2002). A good example from the smaller economies comes from Denmark, where the Nørby Committee published their recommendations for corporate governance in summer 2002, key areas of which are presented in the following table. (Haapanen et al. 2002)

Table 4: New Trends of Corporate Governance

| *Key areas to develop in Corporate Governance* |
|---|
| Role of shareholders and their interaction with the company |
| Role and meaning of stakeholder groups |
| Openness and transparency |
| Tasks and responsibilities of the Board |
| Composition of the Board |
| Compensation of Board and management |
| Risk management |

Still, despite an ongoing convergence of governance mechanisms, practices vary greatly in various countries for a number of reasons (Denis and McConnell 2003). For instance, while in the US the ownership has traditionally been spread among many small shareholders requiring governance to control the management on behalf of the weak individual owners, in Europe there have always been many large institutional owners and cross-ownership between major companies, making governance focus on keeping the shares liquid and protecting the benefits of all of the shareholders, not just the major ones (Haapanen et al. 2002). In Asia, families have traditionally been the key source of capital, contacts and customers, a fact which is changing slowly as the modern heir may have an MBA from Harvard and both local and international investors are demanding more open and respectable operation from the companies they work with (Economist 2003).

Turkey represents an emerging market and as such it sees the need for developing its governance culture (Ararat and Ugur 2003), yet Russia and the Eastern European countries with their privatization processes and communist tradition are yet another issue altogether (see eg. Frydman et al. 1996). After all, enterprise is blooming in Russia with 15 times more registered companies in 2000 than ten years earlier, but the extremely rich oligarchs who took advantage of the privatizations of public companies amidst the chaos are not showing an encouraging example when it comes to complying with “western” governance rules (Liuhto 2001).

Drawing a conclusion from this, we should not take it for granted that all countries should converge on the market-based model prevalent in the US. Many countries have unique legal, cultural and political conditions, which the governance systems have to reflect, resulting in a different constellation of rules, regulations and institutions to organize and monitor the modern corporation (Kaen 2003). However, understanding the relationship between governance mechanisms and the value of the economies and companies within them is important, as emerging markets look to the developed markets to decide how to set up their own corporate governance systems (Denis and McConnell 2003).

**Corporate Governance in Small Companies**

It is tempting to think that the corporate governance only concerns major listed companies. Yet the elements of good corporate governance are just as vital to smaller companies, especially when management and the owners are not the same people (Lawson 1994). In small companies, the rules are somewhat different when compared e.g. to companies traded publicly, which are the *de facto* benchmark of traditional corporate governance. Ownership and management are usually still tied together, at least to certain extent, and outside control and governance is much more relaxed and less demanding than in companies living under the pressure of disclosing every vital detail to the stock market. The close connection between the owners may even lead to relational governance, which is another dimension in addition to the contractual governance, referring to stakeholders having to take account of the longevity of their social relationships between each other (Mustakallio 2002).

Family companies are often centered around the expertise of the founder-entrepreneur and their management practices are informal as they are part of daily operations instead of being conducted as formal meetings (Paasio and Heinonen 1993). The working mode is entrepreneurial as opposed to administrative, and if there is a board, it usually consists of relatives and acquaintances with no real decision power (Koiranen 1998). This may be beneficial for family companies and even for small companies in general, as it keeps the organization lean and effective. In larger establishments authoritative leading practices are more likely to lead to trouble as proven by numerous examples, such as Vivendi in France and Amer in Finland (Haapanen et al. 2002, Näsi et al. 1996).

Reflecting on the notions of agency theory as presented in Chapter 2.5.2, it is essential to have governance mechanisms in place or to be prepared to set them up to attract investment. In fact, it is advisable to have them in place before the investment takes place, as investors are willing to pay more for stock in demonstrably well governed companies (Watts 2002). The legislations of nations and ethics of individuals vary, however, leaving room for variation in set-up and practice of these governance mechanisms. Nevertheless, as noted by Higgs (2003), non-executive directors are custodians of governance. Therefore, we will concentrate on board work in the next chapter.

### 2.5.5 Board Work – Participatory Governance by Outsiders and Insiders

The board of directors is an entity consisting of representatives of the owners who have elected them to look after their interests in the company. It is the official first line of defense against managers who act contrary to shareholders' interests (Denis and McConnell 2003). Others view the board as an important contributor to the strategy process working on the strategy level, leaving execution to the operative personnel of the company. But that is where the definitions end. The boards of real life are very diverse and board work itself has traditionally been somewhat ambivalent. Nevertheless, while corporate governance is centered around the concept of control, board work is about participation.

Autonomous entrepreneurs may perceive the board as an unnecessary evil, while the board members may think of their positions as "honorary" or "formal", paying little or nothing. And if the entrepreneur or other owners of a company do not expect anything from the board, this reflects on the operation of the board. In practice, the board "setting the strategic direction" of a rural auto body shop may consist of the welder himself accompanied by his wife, having a meeting on paper once a year, while the board members of the national telephone monopoly are elected from among politicians according to their pecking order. In a typical high-tech start-up the inventors found the company and form the board as well, with little output resulting from the practically non-existent board work. But in the best case an established SME takes advantage of the opportunity by composing a well-balanced board with outside experts and executives sitting in well-prepared meetings every month.

However, recent mishaps in corporate governance and the work of board members in companies ranging from small to major has sparked a mass of debate about the duties and responsibilities of board members and put the board work in a new light. Some argue that the main reason for the Enron crash was not lack of regulations or the deceptions of executives but rather a failure of the board to function morally, despite their impeccable resumés (Zandstra 2002). Thus, board members can no longer merely "sit" on the board: they have to know their duties and responsibilities as board members and be concerned for the company if for no other reason then at least to cover their own backs.

Simultaneously, more demands arise from companies and their owners, as more and more of them start seeing the board as an asset and potential advantage (Veranen 1996). After all, the competitive environment is growing more harsh and difficult to navigate in, and an experienced board brings welcome help to strategic work. This sets a baseline for board work in due form, with outside members complementing executive members and openness and dialogue being the guiding principles (Higgs 2003). And after all, as one author puts it: Why not assemble a group of experts of various fields together with an investor or two as a board of directors and watch the free advice roll in? (Mehta 2002)

Appealing as this sounds, assembling a well-functioning board fitting the above description is not easy. Yet, if membership of the board consists of full-time employees, typically the founders, as in the start-up example presented earlier in this chapter, there is little added value from the board work. The members see each other often enough during their daily work, and have enough work to do even without "unnecessary" board meetings. Recruiting relatives does not help, as their work will not be objective. In these cases the owners should critically think whether the ownership makes them good board members or not (Veranen 1996).

**Non-Executive Directors and Small Companies**

Having outside directors is essential to the value and output of the board. Outside or non-executive directors, often called NED for short (see e.g. Lawson 1994, Barrow 2001, Deakins et al. 2000 and 2001, Cree 2003), have traditionally been introduced to high-growth companies after a venture capital investment has been made (Gompers and Lerner 1999). Typically, the VC wants to appoint two members of the board, one of whom is a real NED while the other is the representative of the venture capital company, although sometimes the VC's are hesitant to join the board due to liability issues and choose to merely be present in the meetings instead (Gladstone and Gladstone 2002) – so much for commitment!

Their role is to oversee that the invested funds are used in compliance with the business plan and keep the VC company informed. Neither of these tasks resembles the job description of a director in a big corporation. More recently, however, the role of a director in an SME has changed as well and a new set of responsibilities is coming into play. Also, during the dot-com boom around the turn of the millennium, an NED might have realized that he was sitting on the board of a public company, even though what he joined two years earlier was a fledgling company looking for start-up capital. (Barrow 2001)

Nevertheless, the fact that venture capitalist involvement is the trigger for meticulous and constructive board work suggests that there is a longer tradition of this in the developed VC countries. This is at least partially true, and in the US the studies have actually focused on the added value generated by the outside directors to the entrepreneurial team (Deakins et al. 2000). In the European context the main attention is on long-term planning, although most of the studies are concerned with large corporations. There is little knowledge available about the role of boards in smaller companies, family firms, owner-managed firms, start-ups, entrepreneurial or fast growth firms (Huse 1998) although it has been shown that even in family firms having an active board with outside members yields better decision-making practices, resulting in improved profitability and faster growth (Mustakallio 2002).

Utilizing the potential of the outside board members, such as non-executive directors, requires a good working relationship between them and the CEOs and entrepreneurs or other insiders in small growth companies (Deakins et al. 2001). In fact, in small companies the role of a board member sometimes turns into that of a mentor or a trusted friend, in whom the issues and problems could be confided and then discussed in confidence (ibid.). Compability is also advantageous in crises and revolutions as the roles of board and management may change depending on the situation. For instance, the board in a *refinancing* company is monitoring the actions of the managers, while in a *recovery* company they legitimize the management's decision, yet in *reorganization* company the board has an advisory role (Huse 1998).

**Finding Board Members**

The most obvious means of finding outside board members is word-of-mouth; through recommendations and networking. Tapping a mentor, a community leader or a retired executive who used to work for a competitor or potential customer is one way (Mehta 2002). Also fairly early retirees, sometimes released from their high position with a reasonable parachute, are prime candidates for joining start-up boards and filling in the experience gap (Bartlett 1999). Chartered accountants, through their training and experience, have many of the appropriate skills to be effective NEDs (Lawson 1994). Yet another suggestion is to look at larger corporations just below board level; these new directors get valuable education in board practice and may prove to be energetic and dynamic due to enthusiasm (Cree 2003).

Using recruitment agencies for locating non-executive directors is often too expensive for small companies even though there are some, such as Odgers Ray & Berndson in the UK (http://www.odgers.com/), who maintain special databases for NED candidates mainly targeted at public companies. Advertising in newspapers may yield patchy results and the “same old faces”. If the board is to be reinforced due to VC investment, the investor should be able to provide suitable leads on top of nominating a director from inside their own ranks. There are also organized business organizations, which specialize in finding and matching board directors. (Cree 2003)

These organizations are many and varied but in some form they can be found all over. In the US, the Directorship Search Group (www.directorship.com) consults in executive search, management succession planning and corporate governance, while the UK-based Directorbank Executive Search (www.directorbank.com) serves venture capital companies and financial institutions in Europe. Even in the small market of Finland, there are several operatives offering board members, usually among other consulting services, or matching services for presenting board member candidates for companies in need, and vice versa, as presented in the following.

Hallituspartnerit is an association registered in early 2003 and has 13 invited members, the main objective being to offer the members to companies as board members. They are also offered to other consultative services such as change of generation or matching investors and investment targets. Since the initiative for the association emerged from the local chamber of commerce, they also aim at promoting and developing board work. Presumably, the partners themselves may wish to act as business angels, making this entity partially a marketing organization for business angels or an informal business angel network.

A very similar organization is Boardman Oy (http://www.boardman.fi/) with its 15 founders and partners, practically all of whom are renowned persons from the fields of business, politics or academia, or Nestor Partners with it’s 51 members, both listing a number of other uses for their members besides board membership, including advisory services in privatization, strategic management, internationalisation or reorganization, but does not especially promote their involvement in fundraising or investment matching. Some of these organizations were also discussed in Chapter 2.4.3 on mentoring, but despite many similarities their members were deemed not to be mentors due to their tendency to require compensation for their work.

Besides matching directors and companies, there are many ways of trying to make board work more appreciated and effective. Of the major venture capital companies, 3i for example has a program called Independent Director’s Programme, or IDP for short, in which in mid-2002 they had more than 600 members in 14 countries, sitting on about 1200 boards. According to Patrick Dunne of 3i, having a good board in the investee company earns more money than having a bad one. (3imail 2002)

On average, the directors of the IDP program are slightly over 50 years of age, although they range from under 40 up to 70 years. The members have to be both financially and professionally independent when joining. This naturally limits the selection and availability of suitable people. Additionally, through this “pool” the directors are only available to 3i portfolio companies, even though only half of the total number of board seats of the IDP directors are in 3i-backed companies (3i 2003). With the aid of IDP 3i says they have suitable candidates available with 24 hour stand-by when necessary; and sometimes speed is essential, even if the claimed annual savings of €7M were not reason enough for the existence of the programme. (Rantanen 2002)

One of the IDP members, Ari Heiniö, appreciates the IDP for its ability to connect the skills of experienced (ex-)managers with the needs of companies. "It would be a waste not to use the diversified experience brought by years of work leadership positions", he says. He also considers the members-only website, IDP Online (www.3i-idp.com), a valuable tool in creating one's network and receiving advice on questions out of one's own range of expertise. In his view the role of the board in steering the company in the right strategic directions must not be forgotten for a moment, but on the other hand the board also has to leave the management enough freedom to take care of the operative work. (3imail 2002)

**Costs and Benefits of an Active Board**

As for the compensation of board work, nobody should any longer expect the board members to work for free. The very minimum is to pay the expenses related to the board work, on top of which a minimal stake of equity could be considered in the case of a start-up (Mehta 2002). This is quite customary especially among IT start-ups and other "hot" companies, but also among more mature companies; for example in Finland, two thirds of companies with New Market listing offer an option plan to their board members, and 40% of companies quoted on the main list use either stock or stock options in remunerating their board directors (Haapanen et al. 2002).

The "expenses paid" will rarely sustain the board for long. Fortunately, there are numerous alternatives in setting up the compensation plan including combinations of monthly and annual fees with or without an additional compensation for each meeting (Haapanen et al. 2002). As noted earlier, adding cheap equity to the compensation plan is almost a standard practice (Bartlett 1999) and will also provide the director with both a vested interest and upside potential to cover the time he invests in the company. And even not paying anything initially can be covered with a profit-sharing deal.

The potential benefits of a good board, especially when filled by outside members, are numerous and partially self-evident. In addition to the monitoring role, a number of writers have raised their importance in bringing improved discipline in board meetings, exercising leadership skills and improving the general functioning of the board. Earlier research also shows that NEDs may also bring their informal networks at the disposal of the company, providing contacts in new markets and in acquiring resources, and can improve the credibility of a firm in new markets. (Deakins et al. 2000)

As described by Hugh Ward, who joined the board of a three-year old software consultancy company, Performa Global, as its first outside board member in mid-2002: "I am helping them to define strategy and question performance relative to targets and strategy. I'm getting them to think about business risk – what would happen if one of the key directors went under a bus or a major client was taken over? And I'm helping with people development, mentoring the senior people". Personally, he sees that his main role is bringing experience to the boardroom, but we can see that working as a devil's advocate is another important part of the NED's role. (Cree 2003).

Interestingly, when thinking of the added value of an outside board member the other way around the VCs can claim that it is the entry of a VC which brings this added value in the form of more valuable NEDs and board work in general than before (Deakins et al. 2000). As one entrepreneur reports this in his own case, entry of the VC did indeed systematize the board work. It clarified the division of labor between board and CEO, crystallized the goals for the management team, helped in creating a driving force and required well prepared monthly reports, trusting the company to the board and management team at the same time. The board members “wore the company hat” in the meetings, presenting and questioning ideas openly and in accordance with the chosen strategy and objectives. The board convened regularly and consisted of members with experience of board work in various fields. (Saari 2002)

A caveat or two is appropriate, however, when speaking about board work and venture capitalists at the same time: many a term sheet includes a provision for a *control flip*, meaning that the investors are content with a minority in the board as long as everything goes well, but gain control over the company by majority in the board if the company gets into trouble. Occurrences triggering the control flip may vary from not meeting a set benchmark to more serious reasons, such as violating the negative covenants in the shareholder’s agreement (Bartlett 1999). And during the inevitable turbulent seasons, a seasoned, grey-haired VC is worth his weight in gold, while the arrogant newcomers with no operating experience may be a major hindrance, causing more trouble than rendering help (Nesheim 2000).

All in all, an optimal outside director, especially from the entrepreneur’s and CEO’s point-of-view, is a short-term advisor, a long-term mentor and a counsellor at all times (Deakins et al. 2000). Trust is of the essence as effective work requires open discussion with all data available, just as is the case in mentoring as described in Chapter 2.4.3 (Deakins et al. 2000, Haapanen et al. 2002, Saari 2002). One should rely on the board for the major guidance to get the most of it, and not to ask for day-to-day advice to substitute for a strong management team (Mehta 2002).

**Summary**

The board of directors is the owners’ tool for monitoring their property – the company - and those who have been given the authority to manage it. In corporations the operation of the board has been quite active as it is more or less the only way for the owners to have control over the company. The situation in small companies run by owner-managers has been quite the contrary, as the board has been seen as an unnecessary entity by the entrepreneur who both runs the company and owns it.

The situation in a small company is quite different if there are multiple owners, and especially when an outside owner, such as a business angel or venture capitalist, is involved. In these cases the monitoring function becomes essential. On the other hand, the venture may also acquire added value from the board: a good board with talented members from outside the company can be used to genuinely guide the strategic direction of the company and as a sounding board for the management. Finding good members and achieving mutual trust may take some effort, but may be expected to bring positive outcome in the end.

## 2.6 Venture-to-Capital – Towards the New Discipline

The growth business process, as we see it, concerns the companies having potential for great success. Due to the laws of nature and business they therefore also carry the highest risks and challenges. Having little or no revenue, high growth high-tech start-ups cannot sustain the development of their product and overall business without outside financing. And even if the product were there, successful introduction to the market and the financial pressures associated with growth require further financing, as well as skills. Reflecting on the previous chapters we can say that hiring engineers and managers, raising capital, keeping the product development milestones and keeping all interested parties satisfied are four different parts of the equation.

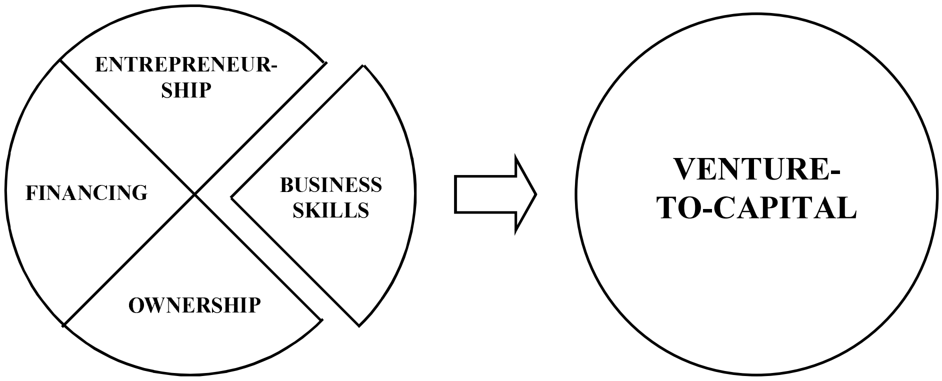


Figure 24: Venture-to-Capital Paradigm Pie

As it is all about taking a new *venture* towards a point where it can be supported by the institutionalized *capital* market, we call this discipline *Venture-to-Capital*. It draws heavily on all the disciplines discussed in the foregoing – entrepreneurship, private equity finance, ownership and management. Let us summarize our findings in each of the four disciplines and crystallize their contribution and requirements to Venture-to-Capital.

*Entrepreneurship* – A venture is based on an entrepreneur and an idea. It is run by the entrepreneur or an entrepreneurial team committed to the success of the company. It is based on an idea of a product or service, and the conviction that a market exists for it. To make the idea into a product and bring it to the market, much effort requiring skills and investments is needed. If we accept that a good team can achieve success with less than a spectacular product, we should also accept the negation of this: many a good product loses its potential in less than a spectacular venture and team and with bad execution.

*Private Equity Financing* – Initially, the company is funded by the founders and individuals closely related to them. It is not yet supported by the formal capital market consisting of banks and stock markets. The aim of formal venture capital is to make the venture eligible for the institutionalised capital market, making it a mediator between venture and institutional capital market. In order to reach the formal venture capital market, the venture has to be made eligible for it with support from other actors.

*Ownership* – The company or its idea is first owned by the nascent entrepreneur. In order to realize the idea, he has to seek financial support from others, such as the 3 F's – other founders, families and friends – in many cases widening the circle of owners. Later, as more resources are needed, the ownership has to be dispersed even more to include key employees as well as formal and informal private equity investors. Ultimately, the venture may reach the goal by becoming part of the public equity market, losing direct control of its ownership but having theoretically unlimited resources.

*Management* – As noted earlier, a dedicated entrepreneurial actor is required to keep the company driven and focused. Although important, leadership alone cannot carry the venture far. The company has to have people with knowledge of several issues at its disposal. The most obvious way is to gather this knowledge as the entrepreneurial team of founders, but since this is rarely applicable – especially if the company has already been founded – the venture should look for good managers from outside, and be prepared to give them an equity stake. To fill in the gaps, outside board directors and mentors can be called in to act as a sounding board.

# 3 Venture-to-Capital as a Framework for Growth Venturing

*"We don't see things as they are. We see them as We are." – Talmud*

This chapter synthesizes the theory of Venture-to-Capital, or V2C for short, as a new framework from existing theory of growth venturing, by defining the key concepts and elements of Venture-to-Capital. It is based on the discussion in the previous chapter about the disciplines forming its foundations: Entrepreneurship, Private Equity Finance, Management and Ownership.

The foundation for Venture-to-Capital as a phenomenon was laid down in 2001 (Seppä and Näsi 2001). Since then, there have been writings on the subject by the initial research team (e.g. Seppä and Rasila 2002, Rasila et al. 2002, Jungman et al. 2002 and 2004, Rasila 2003) but no concept-analytical effort has been made. However, we should not content ourselves with a contemporary look at the subject but also appreciate its history. Therefore, we will approach the subject through the history of growth venturing.

## 3.1 Overview of the History of Business Venturing

The written history of venture capital is not long. American Research and Development, founded in 1946, is usually quoted as the first venture capital company. As soon as we go any further back than that it appears that there is no VC in existence. Investing as a profession, especially when investing to risky companies which are anticipated to be profitable and thus good investments, could seem to be a modern profession in connection with the stock market or at least financial institutions such as banks as we know them today.

What we constantly fail to realize is that the world has been more or less the same for hundreds or thousands of years. Investing professionally and perhaps even more specifically professional ownership has been done throughout the ages, creating added value for entrepreneurs, financiers themselves as well as the economies they operate in by facilitating the success of the target ventures. The changes we look upon as major are merely recurrences of the past, applied differently than before. Therefore, in the pursuit of creating new we must first look at the past.

### 3.1.1 The Beginnings

Lending and investing money is not a new concept, and risk is inherent in both of these. Documents exist, dating back to 1823 BC, that the temple of the god Shamash in Mesopotamia loaned money to a local farmer (Williams et al. 1997). The capital was to be paid back after the next harvest, which gives us the element of financing a venture, in this case one operating in agriculture. Together with payback the lender agreed to pay interest "at the rate set by Shamash" - a practise which could be considered somewhat unusual by modern standards and would probably be a "deal killer" for modern entrepreneurs. In this example, the farmer can be seen as the entrepreneur in need of financing. The priests of Shamash take the risk of lending him the money without collateral, trusting the crops from the next harvest – enabled by the investment - will provide enough income for the entrepreneur to pay back the loan. On the other hand, the entrepreneur takes two risks. First, by taking the loan without being certain about his ability to pay it back, trusting that his venture will succeed. Second, the priests' right to participate in the profits is left open.

Financing of others' ventures is also promoted in e.g. Islam. Even though charging interest on the capital loaned – or more precisely, "usury" – is forbidden (The Quran; Sura 2 "Al-Baqara", verse 276), it is clearly stated that no-one should keep piling up his wealth (The Quran; Sura 104 "Al-Humaza", verses 2-4). Hence, lending money itself is by no means banned, and the Muslim holy book encourages giving more time to debtors in financial difficulty (The Quran; Sura 2 "Al-Baqara", verse 281) and also gives good advice on the practicalities of financial contracts (The Quran; Sura 2 "Al-Baqara", verse 283-284). Remembering that in those days a literate person was hard to find and a female person was legally incompetent in court, such practical advice is worth reading for those who are frustrated with armies of lawyers of today.

The potential of business venturing is also illustrated in Buddhist writings. For example, one of the Jakata stories, Cullaka-Setthi, tells the story of a successful young entrepreneur who found a dead mouse. He grasps the opportunity by selling this to a tavern owner who wants to feed his cat. The proceedings of the transaction he uses to buy sugar, with which he produces sweetened water to sell to florists, who pay him in flowers. He sells the flowers and repeats until he has gained 8 karshapanas. In his next venture, he uses children to collect firewood, paying in sugar. The wood he sells to a potter and gains 16 karshapanas. His ventures go to large scale when he returns to selling water to grass-mowers, taking payment in bundles of grass which he re-sells to horse traders profiting 1000 karshapanas. The culmination point of the story is when the young man uses 8 kasrhapanas to rent a carriage and buys the whole cargo of a newly arrived ship in the port, later retailing the goods to other traders for 200 thousand kasrhapanas. (Cowell 2001)

It is natural that various institutions in ancient days performed the functions of modern banks or other financial institutions, as there were neither of these in existence. There is evidence of bank-like entities in Athens towards the end of the fifth century B.C., but they should be considered as a cross between currency exchange and a pawn-broker. They served merchants who needed to change their coinage to local currency, and accepted money on deposit for foreign traders who had nowhere else to store their valuables or locals who wanted to hide their wealth. And they also lent money – that of their own and that of depositors – with a typical annual interest rate of twelve per cent, even though they paid no interest on money deposited. Bankers were considered to be the last resort, though, as people preferred borrowing from friends or relatives. (William et al. 1997)

### 3.1.2 The Contemporaries of Columbus

The above examples date way farther back than 1946, when the VC began or even the common example of Christopher Columbus as the first case of venture financing. But since his example is widely used, let us reflect on his expedition and see how it fits the venture capital context. There are many similarities between his venture and the business start-ups of today; a poor immigrant from Italy – *a Nascent Entrepreneur* - seeking finance from several royal houses – *the Venture Capitalists* - for his *Innovation*, a new approach to travel between Europe and Asia, which would lead to a huge reduction in logistics costs in trade, among other benefits.

At the end of 15th century, Columbus was convinced that the earth was not flat but round instead. Therefore, by sailing west he would find a convenient route from Europe to India. He presented his well formulated plan – *the Business Plan* - of the "Indies operation" in 1584 to John II, who had become king of Portugal a few years earlier. The king – *an Inexperienced Investor* - did not want to make the decision himself, so he sought the advice from his council – *the Investment Board*. (Grimberg 1982)

His far-fetched claim was not supported by the advisors acting as the *Investment Council*, who thought Columbus was a "loudmouthed bragger, full of imagination and weird ideas". His propositions were said to be vague and the price extraordinary high. Therefore, John II rejected the offer and could thus join Ruthann Quindlen and her VC colleagues giving a lecture at their annual meetings on subject "The Dumbest Decision I Ever Made". In a way, the story compares those about the bank manager who saw the automobile as a fad and refused to invest in the Ford Motor Company, or the president of Western Union, who did not want to take over Alexander Graham Bell's telephone company as he saw no use for such a toy as the telephone (Quindlen 2000).

Instead, Columbus found support from Ferdinand and Isabella of Spain, who kept him waiting for their decision for years, but like the VC's of today were also reluctant to say no, keeping the back door open. In the meantime, brother of Christopher, Bartholomeus, was assisting in *raising the capital* by introducing the plan to the royals of France and England as well, but the funding was turned down. Finally, after turning down the plan once with Ferdinand, Isabella made her name in history by reconsidering and finally deciding to support Columbus' *Venture*. On top of being a purely *Financial Investment*, there were also elements of *Strategic Investment* and *Ethical Investment*; It was crucial for success in the competition of sea-faring nations to find the colonies first. Secondly, one of the key factors pushing the Spanish king and queen to support the venture was the possibility to assist in conversion of numerous heathen people to Christianity. (Maailmanhistorian… 1980)

The rest is history. Even though Columbus shared the fate of many other entrepreneurs by failing to meet his primary objective by missing India, his venture was highly successful, resulting in the discovery of a new continent. For this he was rewarded and eventually made three successive, less spectacular trips over the Atlantic Ocean. But even when he died in 1506, he still did not accept the fact that he had not reached Asia, or the Indies as it was called those days. This resembles the unproductive one-eyed stubbornness still sometimes found among entrepreneurs of today. (Estlander and Hietakari 1966)

As in many cases, the followers become the biggest success stories, and thus the *Household Brand* was created by Amerigo Vespucci, who reported in 1505 that the discovery was in fact a new continent. When his report was published two years later, the publisher proposed in his foreword that the continent should be called America after Vespucci. The other objectives of Columbus were eventually completed by Vasco da Gama, who sailed around Africa and found the route to India, and Magalhães, who sailed around the world 1519-1522. (Grimberg 1982)

To be more precise, Magalhães did not succeed in the task but his expedition did. Part of the reason was that the venture had multiple goals and was therefore not sufficiently focused. Despite his renowned skill as a leader, Magalhães, after crossing the Pacific Ocean and therefore more or less achieving the *primary goal* of proving that the earth is round, lost the *focus* and started converting the natives of the islands to Christianity. The end result was that he and many of his crew were killed in action. (ibid.)

Luckily, his crew - *the Team* - was capable of taking control, regaining focus and continuing the venture. Finally, of the five ships that had left Spain only one returned with 10 per cent of the original crew left. Compared to this, the *commitment* of staff and *downsizing* of personnel of today seem child's play. Nevertheless, although Columbus' journeys did not prove that the earth is round, *entrepreneurial example* by no means prevented other explorers from eventually sailing around the globe and consequently fulfilling the secondary objective of Columbus as well – *Progress, Innovation and Prosperity*. (ibid.)

In those days, banks were already in existence, and unlike the pawnbrokers referred to earlier, some of the banks of Columbus' times are still operating. The oldest bank still in operation is Banca Monte dei Paschi di Siena, founded in 1472 (Banca… 2000), which is 20 years before crew of Columbus shouted "Tierra". But even in those days, the banks were risk-averse and would not loan funds for an international expedition without collateral. Moreover, individual investors probably kept out from these ventures not only because of the big investments and great risks, but also for the fact that they would have been unable to claim the lands for themselves. Thus funding was sought from the royal houses – a practice which would be a fairly tall order for today's entrepreneurs. Luckily, we have other organizations today, including governmental ones.

### 3.1.3 Towards Modern V2C Practices in the Industrial Era

Coming closer to today, a case from the industrial era is presented as the final example. Hirvonen (2002) describes the importance of the "networks of elite" in the 1850's and 1860's by taking one particular person, Alfred Kihlman, as an example. Many interesting analogies between our perceived modern phenomena and their historical predecessors can be found in this study. Indeed, Mr. Kihlman was a business angel without knowing it, and little did his group of people know that they were performing the very tasks of *business angel networks* and *venture capital partnerships*.

The late father of his first wife, Angelica Fabritius, had owned several sawmills, and when she died Kihlman became a wealthy man at less than 30 years of age. Originally a priest, he turned to teaching German as his profession, but soon also started investing his fortunes in various business ventures. He was not a passive bystander, but also rose to the board or directorate of many of these businesses. Today, we would speak of a *business angel* or *hands-on investor*.

His key means for acquiring information about available business deals was the network of like-minded religious brethren – a practice which has many similar examples around the world, including the Quaker networks. When a good and trustworthy opportunity was identified, usually several of these people, some of whom knew the entrepreneur personally, put to money together and funded the venture. Today, we would speak of a *business angel network, deal flow, syndicated investments* and *personal chemistry*.

As an example, having received a loan from the "Manufacturing Fund", guaranteed by four local businessmen, August Alexander Levón had been able to start a mill in Vaasa. In the late 1840's he wanted to modernize his operation by replacing oxen with a steam engine. This investment was too big for him alone, so he asked Fredrik August Birling to join him as a co-entrepreneur. Together they wrote to Kihlman, who funded the investment in this company which later became known as Vaasan Höyrymylly Oy - Vaasa Steam Mill Inc. Today, we would speak of *seed capital, partnering* and *expansion stage funding*.

Another, initially less successful investment was Tampereen Pellava- ja Rautateollisuusosakeyhtiö, the textile mill and heavy machinery company which later became known as Tampella. When Kihlman came in, the financial status of both the company and its founders was already bad, a condition which was cleverly hidden from the stockholders. Finally, when the situation was exposed in spring 1866, the general meeting replaced the whole board of the company as the inner circle had mainly consisted of relatives of the founders. Kihlman was one of those elected, and a year later ended up in the directorate of the bank now in control of the company, Suomen Yhdyspankki, or SYP. Interestingly, this coalition of Tampella and SYP later formed the heart of a major economic power inside Finland, only to meet its fate in early 1990's. Kihlman, however, lived long and prospered, winding up in many other influential as well as political positions. And finally, in the current vocabulary we would speak of T*ake-Over-and-Turn-Around, re-start, networking* and the importance of *corporate governance*.

It should be noted that at that time the banking system was not well developed in Finland. Therefore, the networks of wealthy people were essential for those who needed money to start or enlarge their business, or cover up losses. On the other hand, in dire straits the all-too-tight networks were also a hazard, as everybody owed money to someone and loans were cross-guaranteed. Thus, the collapse of one person endangered the whole structure.

### 3.1.4 Birth of the Venture-to-Capital Discipline

As we can conclude from all the above, venture capital, for example, may appear a fairly recent concept to a contemporary observer, but its functions have existed in one form or another for millennia. After all, the world and the people who inhabit it have been the same for a long time, and the only unchangeable thing is change itself. In our case, only the appearance and names of financial institutions have changed. Their operation and business in general has been constrained by legislation and sometimes even dictated by religious dogma. Nevertheless, the human is still the same as a long time ago, and so are the generic principles of human activities, such as entrepreneurship, venturing and finance.

What has changed, however, is that today the new business venturing is considered to be an important part of economic activities. Years ago labor-intensive industries such as textile mills and mines were hailed as the backbone of Western economies. In the 20$^{th}$ century they made way for corporations, which dominated for decades, until they also started to stagnate and even diminish, being unable to grow at the former rate and provide jobs for a growing number of people. It was noted that even though the big companies were visible, they only provided a small fraction of jobs and gross national production in most countries.

Today, small and medium-sized companies (SME's) are regarded as the most prominent source of economic growth and job creation. Companies need to be founded and developed in order to compensate for the losses of jobs in large companies operating in traditional industries. Therefore, it is a crucial interest of economies to facilitate both the initial birth and eventual growth of the fledgling companies. Furthermore, new growth ventures of today face global competition from the very start, and have to grow ever faster to gain a sustainable position on the market. Even if we forget the ridicule of the dot-com era, in order to succeed these emerging growth ventures should have an ample amount of resources at their disposal, including skillful and experienced personnel and solid financial backing.

This is neither an easy nor a straightforward task, but a lot is done all the time. Numerous government incentives exist in various countries, promoting emergence of entrepreneurs and their enterprises. Also, many kinds of private sector operatives have developed to aid the new and fast-growing ventures in financing and managing the company during the many challenges associated with growth. Some of them offer financing, as business angels and venture capitalists do, others concentrate on consultation and other services, as done by advisors and incubators, while business angel networks concentrate on facilitating the matchmaking between entrepreneurs and financiers.

## 3.2 Birth of the V2C Space[10]

During decades of evolution, VC companies have shifted their focus from involvement-intensive seed- and start-up phase investments to larger size investments creating an imbalance of demand and supply for certain levels of finance. Several reasons can be seen as contributors to this development. First of all, the costs of due diligence and management are basically the same regardless of the investment size, steering the investment size up for cost-efficiency. Secondly, the perceived high risks and unproven returns associated with investing in early stage companies with no track record create a barrier for the investment. To conclude, inadequate information about venture capital as an alternative for financing among entrepreneurs and the fact that venture capital may not be the best financing method for all SMEs in the first place lead to inadequate deal flow for investors. (Harding 2002)

This essentially pushes the VCs towards more “cost effective” later stage investments, such as Management Buy-In and Buy-Out (MBO and MBI, respectively) and bridge funding for pre-IPO, meaning low-risk private placement preceding public listing, i.e. initial public offering. Typical characteristics of these later-stage investments 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 figure. 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 fairly good probability. Conceptually, the investment managers just need to monitor the market and pick the ones which suit the portfolio of their funds.

[10] This chapter is largely adapted from Rasila et al. 2002.

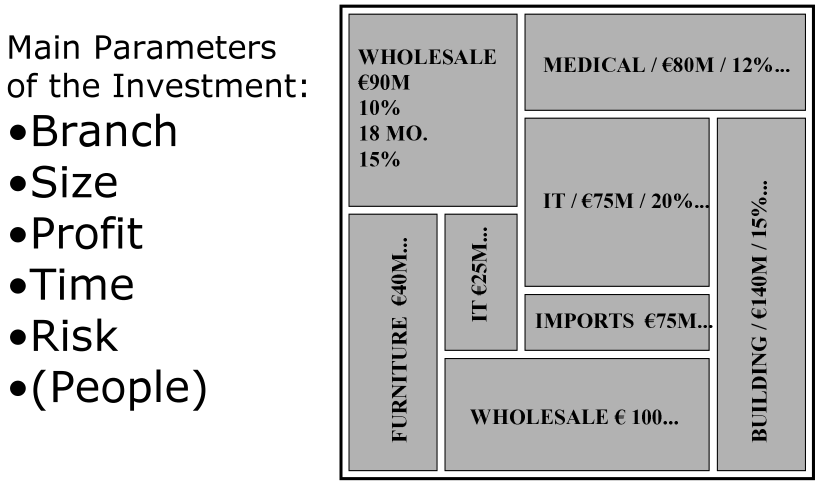


Figure 25: Simplistic Illustration of a Later Stage Investment Arena – “The Organized Icebox”

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 a promising future
- Usually incomplete team of managers
- Lucrative income prospects with high risk
- Long to extremely long investment term

To illustrate this market in contrast with the later-stage arena featured Figure 25, a drawing with several areas within each other can be drawn. The largest area consists of all ventures, be they life-style, income-compensating or growth-oriented in nature. A smaller portion of these are the companies worth considering for a venture capital investment for their growth potential. The key from the investors’ point-of-view is to identify these prospective ventures from the pool of all ventures and select some of them for investment. These form the nucleus of our illustration; the ventures worth investing in. Yet, only the very core of these companies brings back profit to the investor through a successful exit, usually by trade sale or flotation. These profitable investments are depicted by the start inside the nucleus. It is easy to see that picking up the “winners forming the star team” from the vast number of all companies is not an easy task.

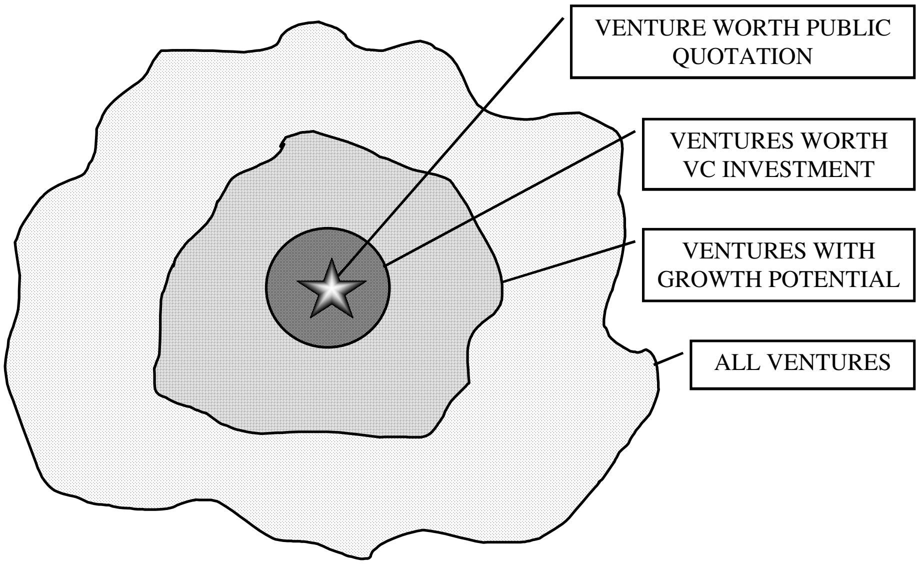


Figure 26: Simplistic Illustration of Early Stage Investment Arena – "The Impenetrable Cloud"

To attain even one IPO within the star in the middle section of the cloud, or let us say cake, an investor has to cut a piece of the cake and eat it all. And "eating all" means that all ventures have to be found and screened, some chosen for 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 in 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.

Reflecting on the findings of Harding (2002), this means that there are companies looking for investment at the same time as many fund managers are telling about companies which have failed to take advantage of venture capital investment and as a result have either failed or been taken over. This suggests two kinds of deficiencies. First, there is an asymmetry between the supply of and demand for equity capital, leading to an *Equity Gap*. Secondly, there is an asymmetry or perhaps more precisely a lack of information between the investors and target companies, which can be called a *Matching Gap*.

Yet it can be argued that every company possesses growth potential and would thus benefit from venture capital funding (Harding 2002). Addressing this issue simply by raising the supply will not work, as work needs to be done among and inside the target companies first to make them ready for investment and after that to nurture them towards success using the additional resources enabled by the investment. But helping the early-stage companies, many of them technology-oriented, not only requires a substantial investment of time but also a special set of skills from the investor.

Still, the earlier the entrepreneur makes contact with professional and experienced actors within the informal venture field the earlier his expectations regarding future cooperation with a possible business angel will be molded in a realistic shape (Svendsen 2002). Unfortunately, as discussed in Chapter 2.2.3, the majority of venture capitalists have grown out of the small business sector, and even business angels have limited and uneven sets of skills. This asymmetry between the Competences required by ventures and those offered by the investors can be called *Competence Gap*.

Based on the preceding discussions about history and the development of business venturing and venture capital, we now analyze the three factors as the main contributors in the birth of the Venture-to-Capital arena:

- Equity Gap – mismatch between the early-stage ventures seeking modest amounts of high-risk equity investment and institutionalized investors, who prefer to make larger, more cost-effective investments with lower risk (a.k.a. capital gap, funding gap, financing gap)

- Competence Gap - mismatch between the early-stage ventures skilled in technological aspects but in need of assistance in various business-oriented issues, and investors who have limited or no capabilities to help or are unwilling to contribute their time to help the company.

- Matching Gap – mismatch between the early-stage ventures who are seeking investment, and the informal investors, who they do not reach even if they were eligible for an informal venture capital investment.

### 3.2.1 Equity Gap

For the reasons stated earlier, there is a major obstacle faced especially by small ventures in raising capital: equity gap, making the minimum investment limit too high for many start-up companies. This may block the venture capital investment even if the three key factors - Market, Product and Team – are in good order. Equity Gap was first found and documented in the 1930's, referred to as the MacMillan Gap in a government study in the UK more than seventy years ago (MacMillan 1931, Dominguez 1974). MacMillan noted the lack of provision for funding for SMEs, an observation which was confirmed 40 years later in the Bolton Report (Bolton 1971). By now equity gap is a widely used term in the venture capital context both in scientific literature, newsletters and newspaper articles (see e.g. Cressy and Cowling 1994a and 1994b, Lonsdale 1995, Cartwright and Orpen 1997, Gracie 1999, Johnstone and Lionais 2000, Bushrod 2002c and 2003) and its existence has been proved in numerous studies (see e.g. Bannock 1991, Murray 1994, Johnstone and Lionais 2000).

Wall (1995) illustrates the effect of equity gap using a hypothetical story:
- "A new business is born and obtains modest (usually short-term) credit facilities from its bankers.
- The capital base is small and the entrepreneur, flushed with success, starts to overtrade.
- Security ratios, balance sheet ratios and interest cover ratios all point to limitations in the ability to obtain further bank facilities - especially at the bottom of the banking cycle.
- The business has a capital requirement that is too small to be of interest to insurance companies, pension funds or most venture capital funds.
- The only option that the new business has is simply to make do -- if it can!"

Wall's article is centered around clearing banks and their role in start-up financing, which explains why business angels and love money are not mentioned as sources for initial funding. Neither is the impact of public sector funding taken into account. Indeed, the birth of equity gap is connected to several interlinked issues, including the apparent reluctance of entrepreneurs to permit external involvement called "control aversion", the structure of financial markets and availability of clearing bank finance. In certain markets all financing is provided by institutional investors favoring larger firms, while others host an active informal and/or formal venture capital investment community. (Cressy and Cowling 1994a)

Still, the message is clear; at some point the young growth companies face a situation where they need more money to keep on growing. The lack of collateral other than intellectual property rights, coupled with the commercial and technical risks associated with novel and unproven technologies make these firms unattractive to risk adverse providers of debt finance, such as banks (Murray 1994). Many of these companies find their funding in the informal venture capital sector (Coveney and Moore 1997), but at the same time the capital needs of many young companies are already too big for informal venture capital and too small for formal venture capitalists.

Effectively, the size of the Equity Gap 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. These can be defined as the boundaries of the V2C market, as they define the distance a venture has to travel on its own in order to reach the formal capital market, consisting of banks, stock exchange and - especially in this context - venture capital. This gap of capital is typically the wider – and the V2C market the bigger – the smaller, younger and more innovative the underlying prospective ventures are. The following figure illustrates the equity gap area.

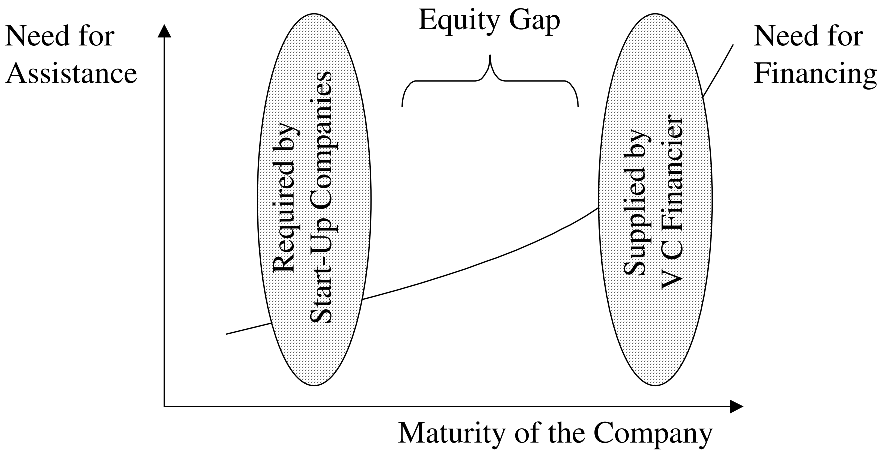


Figure 27: The Equity Gap (adapted from Rasila et al. 2002)

The existence of the Equity Gap can be seen as a negative phenomenon, as it threatens the prospects of young businesses. This in turn has economic implications e.g. by reducing the ability of communities to recover the jobs lost in large companies. (Johnstone and Lionais 2000) Studies have shown that timely availability of early-stage financing and technical assistance can have a substantial, positive impact on a company's immediate growth, employment and long-term revenue (Gregory 1998) and that NTBF's are particularly vulnerable to shortages of adequate financing in their formative periods (Murray 1994).

Today, presence of the equity gap is evident and leads to trouble for those seeking small-scale investment. Several different figures for the size and boundaries of the gap can be found, varying according to the time, place and author of the source. In a recent EU study the range of €5 million was found to be the preferred minimum investment of venture capitalists, thus representing the upper limit of the equity gap (eForum 2001). Roughly the same figure emerged 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 equity gap problem.

In the latter part of the past century, the VC industry was seen as the solution to the equity 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. Unfortunately, merely adding capital to the VC pool does not solve the problem but, on the contrary, the minimum investment goes up with the average fund size. Earlier in the 90's the argument in the UK was that it is uneconomic to provide equity finance in amounts of less than £125,000 (Cressy and Cowling 1994b), while slightly later the equity gap was defined to be a shortage in the supply of equity finance under £400,000 (Lonsdale 1995). Currently, the average amount of capital per VC partner has increased to the point that many venture capital firms cannot afford the time to consider investments under $2 million (Benjamin and Margulis 2000). Nevertheless, in 1999 it was said to be easier to raise £5 million than £50,000 (Gracie 1999), which is dramatically more than even the average investment of USD865,000 by the National Venture Capital Association member companies in 1987 (Maier and Walker 1987).

The exact figures vary from source to source, but overall it has been observed that professionally managed venture pools are less and less interested in the seed round (Bartlett 1999) and the increase in number and volume of early stage financings has not been commensurate with the overall growth of the venture capital industry (Bannock 1991). The inefficiency of the market between those seeking for capital and those supplying it hinders investment under $4 million (Business Angels International 2003). In the US, professional fund managers seek bigger companies, which may develop into $50-100 million businesses within three to five years and rarely get involved in deals smaller than $3 million to $7 million (Benjamin and Margulis 2000). In a survey done on the UK venture capital industry in 1992 start-up finance was ranked as seventh choice on a list of nine investment categories, while seed finance ranked last (Murray 1994).

To summarize the reasons behind this development, the five factors which discourage VCs from providing small amounts of equity and early stage financing may be presented (Bannock 1991):

- The high risk of failure and the more distant prospects of an exit
- The greater investigation costs and due diligence which increase as a percentage of the amount invested
- The poor quality of management teams in businesses seeking finance
- The short-termism of the venture capital industry
- The danger of spreading management resources too thinly across a number of small investments

Due to this, it is rational for the formal venture capital companies to concentrate more in the later stage investments. Consequently, informal venture capital in the form of business angels is heralded as the financiers who will come to the rescue of entrepreneurs and step into the equity gap. (Wall 1995) Creating networks and opening communication channels between angel investors and small companies has the potential to make this investment sector to grow exponentially (Gregory 1998). This can be further promoted by implementing taxation policies and designing investment instruments favoring early-stage investment by seed venture capitalists and informal investors as has been done e.g. in the UK (Cressy and Cowling 1994b, Lonsdale 1995).

Still, even these efforts are partially in vain as they concentrate more on the supply side of investment capital and forget the demand side, i.e. the companies to be invested in. Thus, these measures may reduce the size of the equity gap or guide part of the companies past it, but the demand side deficiencies are a significant reason why small and medium-sized companies are unsuccessful in raising venture capital. In other words, companies are not ready for investment or *investment-ready* and are therefore unable to take advantage of the increased supply of venture capital. (Mason and Harrison 2001a) Many of the companies presented as case examples in Chapter 4 of this study are based on this paradox or assumption: how to prepare companies for growth enabled by investment and hence make them able to exploit the opportunities brought up by the availability of equity investment capital.

Interestingly, Murray (1994) analyzed the equity gap phenomenon and defined two separate equity gaps. The first gap is encountered in trying to obtain the initial funds to create the enterprise. The second gap occurs when attempting to attract sufficient additional funds for substantial development and expansion to full commercial operation after the initial funding from the early stage investor has been exhausted. The equity gap as expressed in this study is closer to the second gap defined by Murray, and from our point-of-view his first gap refers to the general difficulties in receiving initial funding. On the other hand, in his study Murray in a convincing way evaluates the effect of equity gap also from the seed financiers perspective; for them it may effectively be an obstacle for exit. This viewpoint will be elaborated in Chapter 3.3.

### 3.2.2 Competence Gap

Another dimension to fixing the demand and supply side of the equity equation is the need for technical and business assistance in the fledgling companies. In addition to the equity gap, it has been noted that young growth companies are in justified need for good advise to come along with financing (see e.g. Harrison and Mason 1992, Murray 1994, Lumme 1994, Seppä 2000, eForum 2001, Gladstone and Gladstone 2002). A recent EU project conducted by 8 parties in 7 countries found that, not surprisingly, the need for advisors in addition to financing is crucial (eForum 2001). For instance, they may be purely domestic and product-oriented, and need to change this to reach their customers abroad. For this, they need new skills. This is why the investment is made in the first place, only now someone has to compensate the skill deficiencies inside the company so that the money will be used productively.

Working hands-on with the companies used to be the standard operating procedure of the early VC's, who assigned their representative to the board and were available to the entrepreneurs at all times (Bygrave and Timmons 1992). Nowadays, there are many reasons curtailing the financiers' ability to assist their target ventures.

For example, in the US, the number of venture capitalists, i.e. individuals working as investment managers in venture capital companies was 8700 in 2002, and rose up ninefold from 1980 (Brown 2002). It is self-evident that not all of these people can be top performers at once, if ever. Many of them come straight from business schools, or have previously worked for corporations or banks, and thus lack expertise in the small business environment. Of the 125 attendees on the EVCA introductory course for novices in the private equity industry, biggest segment came from banking and brokerage while majority of the rest had their background in consulting, auditing, corporate, tax, legal or government posts. Less than one per cent were former entrepreneurs, compared to those nine per cent who answered "no experience". (Van Gysel and Guennoc 2002)

It would be unrealistic to expect that there would suddenly be a multitude of highly-motivated people skilled in all aspects of grooming start-up companies: entrepreneurship, growth, investment planning, innovation management, research and development, marketing and so on. We can argue that the best venture capitalist has extensive experience both as an entrepreneur and as a venture capitalist, and that this education cannot be imparted by formal education in any institute. Hence, the problem boils down to limited availability of skilled people to act as venture capitalists, and the vast array of skills and experience needed to be one, compared to the limited education alternatives.

The VC managers also have to multitask between a number of companies they actually have invested in, as well as commit a significant amount of their time to screening the incoming business plans. As if dividing their attention between investments in various stages were not demanding enough; one new target is being entered while a more mature one is at the exit stage, the rest being in various states between the chaos of success and desperation of the collapse. As noted by Lars Perkins of Idealab Boston right after the dot-com shakeout: “Most of a VC’s bandwidth is taken up with cleanup work. You’re not looking for new investment opportunities. You’re doing shutdowns, fire sales, and asset liquidations”. (Kirsner 2002)

To further complicate the issue, cost-efficiency urges the VC companies to push their managers to the limit by adding the number of companies per person. By doing this they effectively limit the amount of time devoted to each target company in need of assistance. Not that they would be omnipotent even if they had the time - as noted earlier many of them lack of expertise in the small business environment. This discrepancy is also a major contributor in the existence of the equity gap; we already noted that the cost-efficiency is also compelling VC companies to larger investments. The result is a dual gap as shown in the following figure.

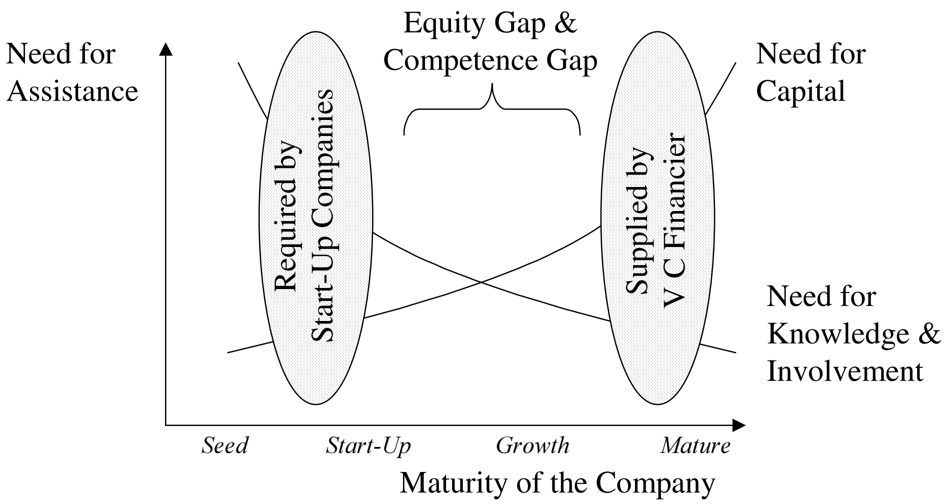


Figure 28: The Equity Gap vs. the Knowledge Gap (adapted from Rasila et al. 2002)

This is not to say that the VC managers do not contribute. Quite the opposite; the EVCA report “The Economic Impact of Venture Capital in Europe” notes that only 12% of investee companies regarded their venture capital investor merely as a “fund manager” while more than half considered him to be a “real partner”. The most important non-cash contributions were considered to be financial advice, assisting in assessing corporate strategy and direction and acting as a sounding board for ideas, each noted by more than over 40% of investees. Other almost as important factors were the manager’s ability to challenge the status quo and provide contacts and market information. (EVCA 1996)

The competence gap is akin to the experience gap referred to by Bartlett (1999), who sees another dimension in the problem. He notes that the start-ups backed by professionally managed venture firms are lucky, as the investor’s representative ordinarily makes an enormous contribution to fill the gaps in the business expertise. This is especially true for the paradigmatic start-up board, consisting of the founder and relatives. Accordingly, a founder is well-advised to offer directorships, coupled with cheap stock, in front of experienced individual businessmen and not limit them to the investors. Numerous events in modern business have provided a large cohort of relatively young and dynamic business people who sometimes neither want nor need to return to a full-time job in large big-company environments, making them prime candidates to help nurture an emerging business to maturity.

There are other sides to both of these coins, however, and subtle issues have to be resolved to fully utilize these potentials. First of all, the advice of the overworked young partner of a VC firm may grate on the founder's ears, especially if the board member's prior experience is limited to attending classes at the Harvard Business School. However, it may be equally troublesome to take advice from someone other than the person who put up the money, particularly a refugee from a big-company culture. (Bartlett 1999)

Apart from the pros and cons discussion the practice described above resembles "bartering", trading of products or services without the use of money as suggested by Benjamin and Margulis (2000). In this case, shares would be bartered for directorships and advisory services, preserving cash for other purposes. This is reality for many operatives who are willing to provide their services to the fledgling companies and share the risk by accepting shares as compensation (see e.g. Virtual CEO in Chapter 4.2.2 or Source Code Finland in Chapter 4.2.3). The reasoning seems plausible at the moment when it is done, and the upside potential of the most profitable cases is supposed to cover the losses of those which end up in bankruptcy, just as is the case with informal and formal venture capital investors. Still, just as in the case of venture capital, there is no such thing as a free lunch: if the venture is highly successful the shares may end up being the most costly method of payment, giving the investor tens of percents of IRR through outstanding trade sale or IPO.

To conclude this chapter we note that it should be beneficial for the venture to mobilize experienced people and professionals to help face the challenges of the early stages of the company. These may be business angels and seed venture capitalists, representing investors, but may also be outsiders called in from the ranks of active or expired executives, entrepreneurs, university teachers and such. In the latter case, the services, such as work as a board director or an advisor, may be compensated with stock, making the person committed to the long-run success of the company.

### 3.2.3 Matching Gap

In an ideal world, all ventures would have high growth potential with their perfect business ideas, and all the wisdom possessed by its founders about this imminent success in the future would be transparently exposed to an unlimited number of investors, ready and willing not only to invest unlimited amount of money but also prepared and skilled to assist the company management in various aspects in company development. Unfortunately, in the real world the situation is different: only a small number of companies succeed, and the scant early stage investors whose attention the fledgling company manages to get will hardly be able to ascertain the lucrativity of the proposed investment deal based on the incomprehensible explanations provided by the technology-oriented inventor-entrepreneur, not to mention that they could help him in his business with which they have no experience from the past.

Indeed, there is ample evidence that both business angels and seed capital funds would invest more if they had more qualified investment proposals at hand (Wetzel 1983, Mason and Harrison 1999, 2002a, 2003a). This need was also built into the "Framework to Increase the Supply of Equity Finance to Small Firms" as suggested by Lonsdale (1995):

> *"Government policy towards the equity gap, therefore, should include initiatives that offer both fiscal incentives and state equity. It should also include measures to improve the mechanisms by which private individual investors come into contact with promising small firms."*

Acknowledging that most of the ventures observed here are not yet fit for venture capital investment, many of them would definitely be attractive for the early stage investors if only they could be introduced to them efficiently. Harding (2002) has identified this information asymmetry and calls it *Knowledge Gap.* As this term would in this dissemination bevome confused with the term *Competence Gap* used for the asymmetry between the skills needed by ventures and those offered by venture capitalists, we call this phenomenon *Matching Gap*.

Harding's observations suggest that this gap persists from both sides. On the demand side, the ventures are not aware that venture capital is a suitable means for growth finance or do not want to give up any part of control to allow their business to grow. On the other side, those supplying the capital do not know about the good, investable projects across all economic sectors (Bean et al. 1975). Filling this matching gap should be at the heart of any policy around venture capital and new business creation. (Harding 2002)

Unlike the equity gap and competence gap, which pre-eminently reside between the ventures and the formal VCs, the matching gap is more imminent between the ventures and informal, private investors, such as the business angels. One of the reasons for its existence is, as noted by Benjamin and Margulis (2000), that private investors are exactly that – private. As noted elsewhere in this study their number is unknowable and it does not serve their purposes to offer their services in public as they would be inundated with investment proposals (Haar et al. 1988). Therefore, it is almost by definition impossible to reach the angel investors directly. This is also true for the researchers, who have to use quite particular methods to reach business angels to study (Lumme et al. 1996).

To overcome this obstacle, business angel networks facilitate the contacts between potential investee companies and private investors, acting as a "firewall" providing confidentiality to the latter. Simultaneously, they assist the companies by exposing them to the investors. A similar "bulletin board" effect can be gained by taking advantage of Internet electronic networks and investment resources. In the height of the dot-com era there was a fair number of these portals, including Wit Capital, Garage.com, MoneySearch, Direct Stock Market, Idea Café, Your Business, and so on. Although they had ample publicity, many of them have ceased to exist. Furthermore, even in 1998 only $44 million was raised through electronic networks, a surprisingly meager figure compared top the total VC investment volume of $30 billion. (Benjamin and Margulis 2000)

Further - and more personal – exposure can be generated by participating in investment meetings, venture forums and conferences gathering both investors and investees in the same place at the same time. These, albeit being an exceptionally good resource for those who can use them, can only provide a limited solution to the problem. First of all, they require a substantial base of both ventures and investors before the trouble of organizing them can be justified. Secondly, they need an organizer. Third, even where available, they are a spurious resource available only from time to time, and full participation in form of public presentation is usually limited to just a few companies.

In addition to getting exposure, a further challenge in matching is provided by the information asymmetry between the investor and the target: it is hard for the potential investors to get enough information and to judge its validity during the due diligence process. Investment banking business had tagged the private capital market as "inefficient", meaning that there are no professional analysts touting the offerings or issuing research reports. No SEC requirement forces disclosure of private offerings, which complicates both buying the shares at the entry of an informal investor and later on the sale of same or additional shares at the exit or further investment to the company by additional investors. (Benjamin and Margulis 2000)

Despite the capital gap it can be argued that there is no lack of pre-IPO capital. Venture capital is abundant, but the source and supply do not match. Furthermore, to bridge the capital gap, there are 2 million investors in the US who by their net worth would qualify as angel investors. Only one-tenth of this group are active. The great challenge of entrepreneurial services and introduction networks is to reach and match with ventures not only the active private investors but also the remaining 90 per cent of them, many of them self-made millionaires who know how to grow a company but not necessarily how to invest in early-stage companies. (Benjamin and Margulis 2000)

Improved opportunities for exposure as well as mobilizing a higher amount of dormant business angels would result in not only a more efficient but also a thicker informal investment market. Business angels being hard to find and – in a sense – a scarce resource, the entrepreneur is often the weaker of the two during negotiations, having to moderate his expectations and demands if the matching is to succeed (Svendsen 2002). If business angels – as well as prospective ventures for that matter – were more visible and available, more bargaining could result and lead not only to fairer conditions but also to better matches between companies and investors.

### 3.2.4 Summary

Venture capital spiral, equity gap, competence gap and matching gap are the main components causing the market to function non-optimally and therefore contributing to the emergence of the Venture-to-Capital Arena. Adapting the findings of Harding (2002) we can conclude that first of all, these gaps represent a major dysfunction in the market, and any enabling policy should be directed towards correcting market dysfunctions like this. Secondly, much of the demand for finance is latent, calling for more information in the market place. To continue, it can be argued that all companies have if not exceptional then at least some growth potential. Consequently, these companies will only have – or be able to realize - this growth potential with some form of non-financial support, in which in practice means mentoring and business support. Finally, investors will only invest if they foresee a profitable exit within reasonable time span, which poses challenges to the exit market.

Whenever there are imperfections or gaps in the free and open market, such as those presented in this chapter, it means that there are unattended clients. And in the world of free competition this means that there is room for new practices or even new kinds of operatives to fulfill the rising needs of the clients. In order to work towards best practices in V2C operation, we need to construct the Venture-to-Capital process as a framework for evaluating V2C operation.

## *3.3 Defining the Venture-to-Capital Process*

In Chapter 2.3.3 we noted that growth in the V2C context is not so much about quantitative growth and absolute numbers, but a challenge of growing from company development stage to another. At the same time, five operational stages in company development were defined:

- Concept
- Seed
- Start-Up
- Growth
- Mature

In the following we develop the Venture-to-Capital concept further by defining what lies between these stages and what differentiates them from each other. First, we look at the milestones, or hurdles, which can conceptually be seen as prerequisites for moving from one stage to another. After that, we analyze the operating mode associated with each stage in V2C context.

### 3.3.1 Milestones of Venturing: Idea, Prospective, Investable and Listable

**Viable**

Conceptually, the lifecycle of a company starts from an idea, a concept of a company developing in the founder's head. In this stage, the company *per se* does not yet exist, and even the idea will cease to exist if the intention of the founder is not fulfilled and a company established (compare with Figure 15). If the founder in his preparative process finds the concept viable, he begins the process of founding the company, and if things work out as intended and no further obstacles emerge, the company is established.

Webster's Dictionary gives a good number of definitions to the word *viable*. First, it quite simply refers to something capable of living, physically fit to live. In physiology, a fetus becomes viable when it reaches a stage of development when it would survive if born; in botany viable refers to being able to live and grow; and in general it means having ability to grow, expand and develop. All these explanations suit well in our context, and even though they refer to bringing up babies or flowers the definitions are analogous with growing businesses.

In our context being fit to life is enough for a company to be viable, as the company then implicitly also has ability to grow and develop. A company which has passed the "viability test" enters the world as a seed-stage company, looking for market to operate and to sell its products and services in. It will not survive the process with the income it can receive from its sales, but is dependent on outside financing just as a new-born baby cannot survive on its own but is dependent on other people's attention and breastfeeding.

**Prospective**

In due course, the company will become more self-sufficient and be able to stand on its own feet. Anyone who has raised a baby and read the story of Bambi (Salten 1954) knows that depending on individual and species this may take a longer and shorter while. In fact, many seed stage companies will find that they were not viable after all, and will cease to exist, never learning to stand. In American VC literature a seed stage company still in its very early stages of development, being in the process of being organized and developing its product (Benjamin and Margulis 2000, Baird 1999). When the product development is being completed and marketing initialized, the seed company is aspiring to become a start-up.

At this point, the surviving companies can be roughly divided into two: the companies with and without growth potential. The first group are the interesting ones from the V2C point-of-view as they are *prospective*. According to Webster's Dictionary, the term prospective means something which is likely, potential or expected to happen in the future. The basic word *prospect* or its plural form *prospects* suggests towards possibility of success or advancement; "something in a view as a source of profit". This fits well with the intended meaning of the term in our context as a firm, which is considered to possess the qualities necessary in becoming a future success.

The companies failing to meet the prospective criteria should be left adrift, as trying to artificially make them grow rapidly or attractive to venture capital investors would be waste of resources, which are used more efficiently working on the inherently prospective companies. This should not be understood as a classification between good and bad companies: the failing companies may be e.g. lifestyle companies which will employ their founders and many others for years to come, exceptionally healthy compared to many of the prospective companies and already broken even. But it is not the financial stability the VC's would be looking after when making investment when the time comes (Koski 2000). Or maybe this is not a mishap after all, since lifestyle companies should turn to banks and conservative business angels for funding.

Therefore, it is effectively the unqualified growth-oriented companies who suffer from being rejected at this phase. Still, this is an act in accordance with Darwinism; those not fit for life would fall at a later stage of life or evolution in any case (Darwin 1905) and it is thus beneficial to reject these companies as early as possible in order to concentrate the efforts on more promising companies. Besides Darwinism, we can reflect on gardening; a skillful gardener does not hesitate to cut the branches of his fruit trees to let the other branches prosper, as long as he knows which branches to cut. Hence, the practice of venture capitalists to mercilessly "pull the plug" of their portfolio companies by denying further investment to those failing to meet the hurdles or milestones is unfortunate for the companies in question, but beneficial for the economy, preventing further damage and – in accordance with the resource-based view (Mintzberg et al. 1998) – freeing the resources for more profitable purposes.

**Investable**

With proper care, the prospective start-up company will grow towards the growth phase in its development. It may still stumble and fall, and the pace of development varies greatly. Pace can be speeded up with the availability of outside resources such as financing and assistance, although the company may also choose to take the longer road and work on its own. By so doing it takes the risk, however, that the competitors will outpace it. Nevertheless, one day the company is *investable*, ready to take advantage of the capital supply offered by venture capital investors.

*Investable*, even if not recognized by all dictionaries or spell checking programs, is not unknown as a word. Webster notes it to be adjective of the verb *invest*, for which it in turn gives 16 explanations, including "to put money to use, by purchase or expenditure, in something offering profitable returns, especially interest or income". An Internet dictionary notes that it can be used as an adjective for something that can be invested, or as a noun synonymous to *investible* for an object suitable as an investment (www.infoplease.com), and a popular Internet search engine produces over 17 thousand hits for the word (www.google.com). Interestingly, it the also has a meaning in stock indices for emerging markets, where "free" and "investable" are jargon for the portion of stock, ownership of which is open to foreigners (The Investment… 2003).

International Capital Resources refers to the same issue using the term *financeable* instead of investable. At the top of their "Is your deal financeable?" checklist is the management with 14 more company and market-oriented considerations following (Benjamin and Margulis 2000). The definition becomes wider if one looks at the FAQ section of their website regarding what the entrepreneur should ask himself before seeking for angel investment: "First, ask whether your company is financeable in terms of its business plan, its valuation, its competition, and a host of other factors. Second, ask yourself if you are financeable. That is, do you have a history of legal problems or other issues capable of raising red flags? Do you have the skills to make the company work? And third, is the risk financeable? If the deal is too risky, an angel will not want it. Investors have told us that they lost money when they got caught up in the entrepreneur's enthusiasm without really evaluating the investment." (ICR 2003)

A quite widely used similar concept is *Investment Ready*, also associated with Investment Ready Programme, an activity addressing the demand side deficiencies in venture capital, a more thorough description of which is presented in the appendices. The term was originally coined in a report by Australia's National Investment Council and Marsden Jacob in 1995 (Mason and Harrison 2003b). Investment readiness means that a given company is ready and willing to take investment, referring to an internal mindset of the managers of the company in question. This is not exactly the same as investable, which refers to the company fulfilling the conditions set for being eligible target for an investment. Thereby, being investment ready is a pre-requisite for becoming investable. (Mason and Harrison 2001a)

The framework of investment-ready brings tools to our discussion on the differences between the V2C stages. Looking at the work of Mason and Harrison, we see that a given company has to possess certain qualities to be "investment ready": It has to have a suitable organization structure, be willing to grow, be prepared to give out a certain amount of ownership and control in exchange for the investment, and so on. In practice, this means that the company has intrinsically prepared itself for being able to absorb the investment and use it for growth (Mason and Harrison 2000a, 2001a and 2002a). Much in the same manner, venture capitalists have their requirements, checklists, and other investment criteria to assist them in screening their prospective target companies. In V2C context, when a company fulfills these investment criteria it becomes investable.

In order to further evaluate and differentiate the definitions of prospective and investable, we should divide the companies seeking equity finance in four groups (Mason and Harrison 2002a):

1. Companies which are investment ready (Mason and Harrison 2001a)
2. Companies which are not investment ready, but for which an investor can provide support either before or after making the investment
3. Companies which could be made investment ready by support
4. Companies not capable of taking an investment

The first of the above categories is called investable in our typology and the second – even if it does not fulfill all the investment criteria at first sight - is close enough for the VC investor to be drawn towards investment and hence also deemed investable. The difficulty from the Venture-to-Capital viewpoint is to differentiate between the companies falling into categories three and four. It is the third category which we define as prospective and thus worthy of the attention of V2C activities, aiming to make those companies investable at some point in the future, while the companies in the fourth category are not seen to possess the qualities and potential required of a high-growth company. These companies may be promising and healthy companies with good prospects, but fall short on e.g. growth potential, mercilessly dropping them from the reach of the VCs for good.

**Listable**

When a given company has reached the status of being investable, our model assumes that it will eventually receive investment. Naturally, there are other alternatives - deciding to do without the investment, getting acquired and so on – but as these are not in the scope of this study we will concentrate on the companies which choose to take the investment. As the VC enters the company as an owner, it is assumed from the principles of venture capital finance that he brings along many functions needed to develop the company further, the ultimate goal being a successful exit (see e.g. Seppä 2000, Harding 2002).

To make an exit, the company has to reach *listable* status, referring to a stage when one of the options for the company is the public listing. The term itself may unintentionally 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). Nevertheless, the requirements for the company to be a listable company fulfill the needs for both IPO and trade sale. Naturally, a company can still "choose" between several options: find its way to the public stock market, continue its existence as a privately-owned company, or cease to exist by merging with another company through acquisition.

The end result is somewhat beyond the scope of this study, however, as the prime target of the venture capitalist and hence also of the growth mode firm is an exit of a VC which is applicable to all the above options. Public listing is an explicit exit for the VC and will make the company a mature company, whereas trade sale is similarly an exit for the VC but the company will essentially cease to exist as an independent entity, making it unavailable as a research object. Continuing as privately-owned company is also possible for a listable company, although in this case the exit would most probably be accomplished by selling the shares back to the company or management – a valid, although rarely lucrative alternative.

**Milestones of Growth Venturing**

This chapter presented the venturing milestones referring to the hurdles conceptually between each consecutive stage in company development: A concept becomes viable; a seed company becomes prospective, a start-up company develops to be investible, and finally a growth company becomes listable, ultimately leading it to maturity. To summarize these venturing milestones and illustrate them in the V2C context, we re-visit Figure 26 labeling the groups of companies in different stages of development according to the classification presented in this chapter.

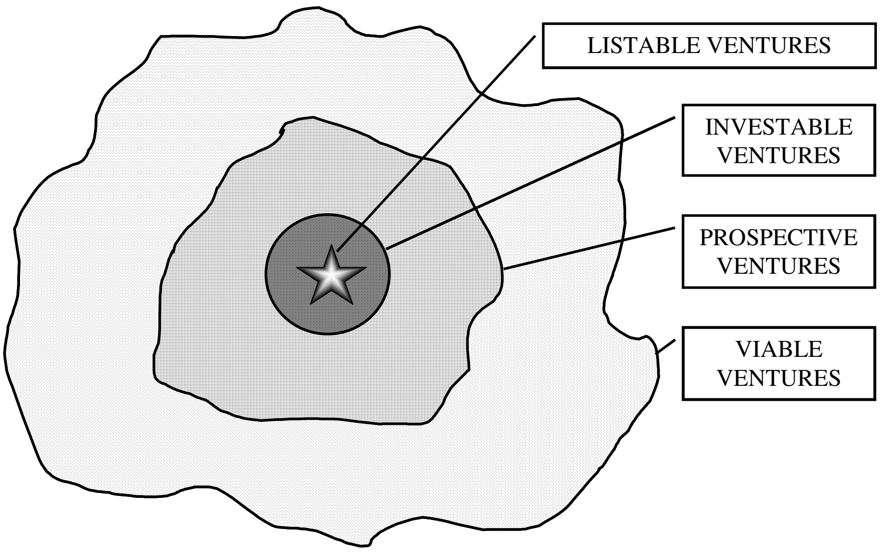


Figure 29: Illustration of V2C Milestones in Growth Ventures

The existing companies are all *viable* ventures by definition, and of those the ventures previously called “worth looking at” are now called *prospective*. Again, the minority of previous which are “worth investing in” are now labeled *investable*. And those “performing a successful exit” are the jewels in the crown, deserving the term *listable*.

## 3.3.2 Operating Modes: Solo, V2C, VC and Public

As the four terms defined in the preceding chapter - viable, prospective, investable and listable – are seen as Venture-to-Capital milestones, we should also define what is between them on the operative level in V2C context. As one of the goals of this study is to define the Venture-to-Capital operative, it is imperative to define its operating ground. We do this by examining the stages of company development in much the same manner as the venture capitalists do when making the distinction between investment rounds.

**Solo Mode**

At first, there is no company but merely an idea of a company, hence the name *concept* for the company phase. The idea is in the head of the founder or founders, who evaluate the viability of the idea as business, in many cases looking for assistance from colleagues or business development advisors. This phase distantly resembles Plato's doctrine of ideas, where the observant only has an idea of something but does not know whether it really exists or not. In his view, getting to know the idea goes through five steps: 1) name or naming; 2) definition or concept; 3) picture; 4) undertanding and science; and 5) sudden, spontaneous comprehension of the idea. (Delius et al. 2000) The same philosophical procedure can also be applied to evaluating and getting to know one's business idea.

In the above-described pre-seed phase of the venture the operation may be part-time, the team is not assembled yet and the business plan is being written. Funding is seldom sought outside the three F's discussed in Chapter 2.2.1, and if it were it would probably not be obtained as the milestones described in the preceding chapter have not yet been reached. The company does not yet exist as a legal entity or is merely registered, waiting to be activated when the time comes. If the founding team finds the idea *viable* they establish the company and start working. They have invested their own money or that of friendly investors closely related to them, and are thus effectively in complete control of their company with all ownership in their own hands. Hence, they have a seed stage company operating in s*olo mode*.

**V2C Mode**

As the Venture-to-Capital context outlined here only applies to growth companies, we assume that at some point in time the company will by definition start looking for outside investment. This seed funding will be sought primarily from informal venture capitalists such as business angels and from formal venture capital companies offering seed capital funding. These are Venture-to-Capital operatives, and the operating mode following their investment is hence called *V2C mode*. At this point, some ownership is often given outside the founding team if this has not already been done, and the new shareholder is – normatively speaking - prepared to take an active role in the development of the *start-up* company.

The role of the V2C operative should be that of an active owner, not merely an investor. During the phase when the company is operating in V2C mode, it is the task of the Venture-to-Capital operative to assist the company towards its medium-range goals. The goal may be to attain stability and profitability as soon as possible to enable the entrepreneur to draw his income from the company. Closer to the context of this study, the goal may be to concentrate on growth at expense of profitability and search for venture capital funding to enable further growth as soon as possible. In any case, guidance by the V2C player is expected to greatly reduce the risk of failure.

In broad terms, taking a company from being a prospective investment target to actually being *investable* consists of development in many areas. To fulfil the requirements imposed by the VC investors the company has to have a product addressing a need in a market with substantial growth potential, and a team which can seize this opportunity and turn it into a success. But once these basic requirements are met there are many other factors which also need attention. The company should be run properly, with books and contracts well maintained. Intellectual property rights should be taken care of, board meetings and their minutes kept and the business plan updated, to name but a few things which have to be taken care of in order not to repel but attract investors.

This “preparatory work” may be considered and formulated as a process, as is done in the case of the Investment Ready Programme presented in the appendices (Mason and Harrison 2001a). From merely trying to increase the availability of venture capital to start-up ventures, the policy makers now accept that the demand side deficiencies have to be addressed as well. The Investment Ready Programme was designed as an instrument to address these deficiencies by making the companies prepared for investment.

Aside from programs aiming at making companies more ready for investment, there are also V2C operatives, which explicitly state that they have a proprietary process of guiding companies towards growth and success, while others a concentrate on certain part of the process. For them, doing their part and then “passing the baton” to the next player or back to the entrepreneur is sufficient. Large number of the V2C players, however, work on an *ad hoc* basis and rely on their experience and instincts when working with a company in *V2C mode*. Overall, deficiencies in current market and hence the need for a new kind of operatives are seen in studies (see e.g. Mason and Harrison 2001a, Harding 2002).

**VC Mode**

The target of V2C operating mode is to reach the *Investable* status and get the company invested in. When the company reaches the operating environment of VC companies, it should be for them to take over and initiate the *VC operating mode*, which is much better defined than V2C Mode due to the practices and tradition of the VC industry. As the *de facto* target of the venture capitalist when entering a company is to make a profitable exit, the inherent aim is to make the company l*istable*, i.e. eligible for initial public offering, trade sale or at least sell-back of shares so that the company can continue operating profitably.

We have to note that the division is not always so clear-cut: V2C players may continue their work during the VC phase just as they may also have been present to certain extent in the initiating phases of a company. The former is especially common in the case of V2C players with an equity stake in the company, as venture capitalists are reluctant to pay for their exit when entering the company, thinking that everyone’s profits should wait until the real exit has been realized. And like V2C operatives, VC’s may also work outside their own arena, helping companies to become *investable* and being involved in recently listed companies in which they still have an equity stake.

**Public**

After the exit the company is either public (in the case of an IPO) or ceases to exist as an independent legal entity (in the case of an acquisition). Thus, since the company only exists after exit *if* it is *public* we use this term for the final, *mature* stage of company development. In the case of an acquisition the ownership and thus control of the target company falls into the hands of the acquiring company. This makes the target uninteresting from the viewpoint of this study, as development and financing of the company are from now on the responsibility of the parent company.

According to the theory of the firm, a public company has finished its journey to adulthood. It no longer needs venture capitalists or informal investors, as – if run properly - its capital needs are catered by the public stock market and banks, of which it is now an eligible customer with a good base of collateral at hand.

### 3.3.3 Effect of V2C Operation on Company Growth and Valuation

Conceptually, the V2C model serves all parties well; entrepreneurs, experts, formal and informal 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. There are also beneficial effects to the company in the growth of its valuation and pace of development towards the exit.

As is the case with VC investment, the valuation of the target company may be expected to rise more rapidly than without investment. However, with V2C the effect is even greater since the accelerated growth can be started from the point when the company is "prospective" instead of the VC having to wait until the target is "investable", in most cases taking 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 use by suitable and devoted people. (Compare with e.g. Rasila et al. 2002)

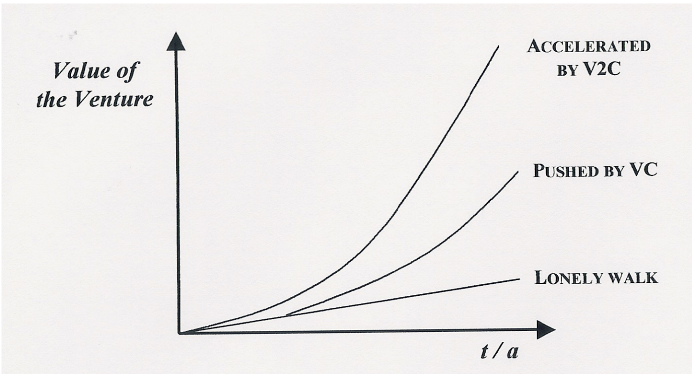


Figure 30: Growth of Company Valuation Using Different Growth Paths (Rasila et al. 2002)

The time span required for each step of development in the company stages can also be accelerated. Conceptually, if the entrepreneur decides to work in solo mode towards a public listing, this in general may take up to 30 years to realize. As a benefit, the founders are still in full ownership possession but the investment time is definitely lengthy. (Seppä and Näsi 2001)

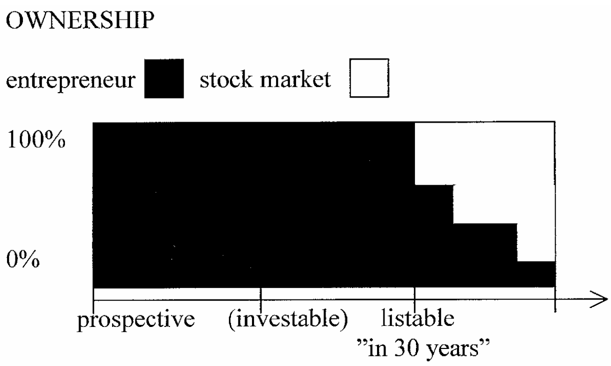


Figure 31: Playing Solo – the Lonely Road of a Prospective Venture to IPO (Seppä and Näsi 2001)

This path may be substantially shortened if the company decides to work towards an investable position and accept a venture capital investment, bringing the additional capital and hence the additional resources to enable fast growth. The VC investor with facilitation by its managers and other non-executive directors will be able to push the investable company to be ready for IPO or trade sale faster than a venture operating in solo mode. For this the investor will take an equity stake in the company until the exit.

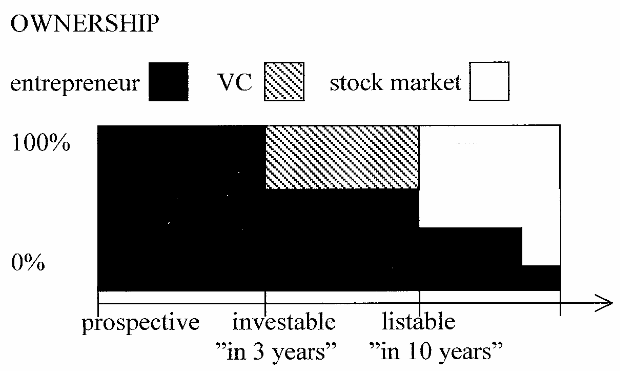


Figure 32: Pushed by VC – the Fast Lane of an Investable Venture to IPO (Seppä and Näsi 2001)

The V2C actor starts working with the company sooner than a VC operative would. The result is two-fold. First, the development to an investable position is faster than without a V2C player. Second, since the company has been geared towards fast growth in V2C mode, i.e. before the VC investment takes place, the development in VC mode may be assumed to be faster than it would without the preparatory work of the V2C player.

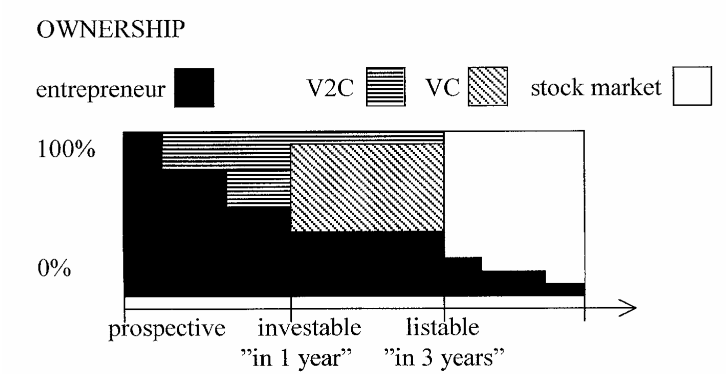


Figure 33: Distribution of Ownership in V2C Model (Seppä and Näsi 2001)

Depending on various parameters, including the actual business model of the V2C actor, the ownership may develop more or less as illustrated in the hypothetical example of Figure 33. Scale is not accurate but the message is clear: V2C actor enters the company at an early stage, holding most of its minority stake until a VC chooses to enter the company. At this point, the V2C actor sells most of its ownership at a 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 "clear them out" from the owners at this point. This is not an obstacle, however, to their continuing with these companies as paid advisors or board members. A more valid obstacle may be the inability of the VC to buy out any part of former owners at its entry, requiring the V2C actor to use other instruments than direct ownership such as convertible loan with suitable payback terms. This can then be paid back from the funds provided to the company by the VC investment.

### 3.3.4 Summary of the Venture-to-Capital Process

The V2C milestones and modus operandi of a company can be illustrated in parallel with the five operational stages in company development presented in the opening of this chapter on page 99. All three aspects are presented side by side in the attached table, together with an illustrative time line.

Table 5: Company Stages and Operating Modes in V2C Context (adapted from Rasila et al. 2002)

| *Company phase* | Seed | Start-Up | Growth | Mature |
|---|---|---|---|---|
| *Target milestone* | From Viable to Prospective | From Prospective to Investable | From Investable to Listable | Listed |
| *Operating mode* | Solo | V2C | VC | Public |
| *Months from start* | 0…24 Months | 6…36 Months | 24…60 Months | 36…120 Months |

The work of a V2C actor is to guide the company from being prospective to becoming investable and hence come within range of the venture capitalists. As noted by Bannock (1991): “The biggest scope for narrowing the equity gap is to give more help to firms to get to the size where formal venture capital is more readily available”. In practise this means making the investee able to absorb the required size of investment. Adding this we can also present the summary as an illustrative picture as is done below.

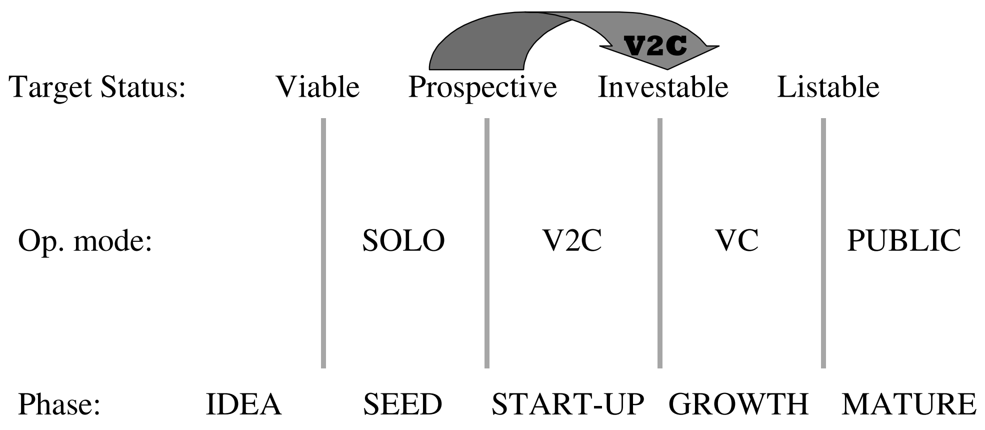


Figure 34. V2C Target Statuses and Phases of Company Development (adapted from Jungman et al. 2002)

When looking at Table 5 and Figure 34 we have to remember that not all companies fit into this model. Not only are the timescales flexible and vary from one company to another, but the majority of the companies overall do not wish to follow the steps outlined here. This was already noted in the limitations when lifestyle companies were restricted from the scope of this study. Our scenario assumes that the company wants to grow fast, expand to several market areas and ultimately make the big time by public listing or trade sale. While we are entitled to assume this within our study, we should never become so narrow-minded as to think that all entrepreneurs see this as the preferred development path for their companies. Quite the opposite, as only a small minority of them do.

Even if we have hereby set forth a framework for V2C operation, the work is not all there. Many open questions remain in the actual work of the V2C operative as well as the criteria used for screening the *viable* ideas. After all, by our definition it is the task for the V2C operative to decide which ones of these companies could be made *investable* and are hence *prospective*, and which ones not. This implies that a prospective company has the potential to become of interest to the venture capital market.

An important point to emphasize here, however, is that even the VC's consider that a fair number of these prospective companies which are for the time being rejected by them possess the potential to become investable if they receive appropriate support – only the VC is not likely to be ready and willing to provide such support (Mason and Harrison 2002a). Similarly, it may be assumed that being rejected by a V2C player is not conclusive, as the decision may be different if done by another V2C operative and/or at later moment. The effect of time is quite straightforward, so the next chapter will discuss the differences between types of V2C operatives.

## *3.4 Traditional Actors in V2C Arena*

*"When I walk along with two others, they may serve me as my teachers." - Confucius*

Many actors exist to assist companies in the V2C operating space. Some of them are funded with public money and are non-profit, others are private organizations or individuals aiming for profit. In this study, these operatives are divided into five distinct classes of traditional V2C actors. The three types identified first were *business angels*, *incubators* and *advisors* (Seppä and Rasila 2002), those added later being *venture capitalists* (VC) making seed stage investments and *business angel networks* (BAN) matching investors and ventures seeking capital (Rasila and Okkonen 2003). All of these actors work with early stage growth companies, yet they all have different business models - including motive, contribution, incentive and revenue models –which will be considered later in this chapter.

Table 6: Classification of Traditional V2C Actors

| *Traditional V2C Actors* |
|---|
| Business Angel |
| Business Angel Network |
| Incubator |
| Advisor |
| Seed Venture Capital |

In past decades, classifications have also been created for sub-classes within each V2C actor group as presented above: Business angels and informal investors (Gaston 1989, Freear et al 1994, Stevenson and Coveney 1994, Sørheim and Landström 2001), incubators (Aernoudt 2002, von Zedtwitz 2003), Matching Portals (Sohl et al. 2000, Van Osnabrugge and Robinson 2000), venture capital companies (Bygrave and Timmons 1992, Seppä 2000) and different forms of corporate venturing (Keil 2000, Chesbrough 2002) have all been studied and taxonomies made. But until the introduction of the Venture-to-Capital (V2C) concept these were not tied together or compared, as there was no common theoretical framework for them.

From the financing point-of-view, there are two opposing pairs within these five classes: business angel and seed VC, who bring money in, and incubator and advisor, who are paid for their services. These pairs also differ in availability: incubators and advisors are more generally available, whereas business angels tend to keep out of sight, and both business angels and seed venture capitalists are scarce to begin with. Business angel network differs from the other classes in the sense that its activity with a venture is usually only one unique transaction, where the venture is introduced to a number of potential investors. The BAN acts as a catalyst, receiving compensation for its efforts from the parties involved and in the usual case has no further interest in the company.

In order to analyze these five archetypical groups of actors and develop the context further, let us have a brief look at the operating principles of each. These actors – incubator, business angel, business angel network, seed venture capitalist and advisor – are not directly comparable, as their objectives are different. In many cases they also complement each other in the field, or just co-exist, instead of competing. In a way this is understandable and positive, since the newly-hatched companies might often be too weak to withstand its aides competing against each other.

The differentiating factors can be found in whether the actor is a private or public entity, as a public entity is usually working at least partially towards other goals than pure financial return. A private entity or an individual usually focuses on financial goals, except in the case of corporate venturing as noted in Chapter 2.2.4. The actors also differ in whether they bring money in or take it out, as noted earlier. Furthermore, we can combine the two by checking whether the money they possibly bring in is their own, or originates from other sources such as other investors or public funds. The time span on which they want to work with the ventures is of great interest, and presumably tied to whether they take an equity stake in the venture, which is an omen for long-term commitment and risk-sharing.

Table 7: Differentiating Factors for V2C Actors

| | |
|---|---|
| Organization | *Entity/Iindividual* |
| Establishment | *Private/Public* |
| Direction of Money | *In/Out/None* |
| Source of Money | *Own/Others/Public* |
| Interest | *Strategic/Financial/Social* |
| Time span | *Short-term/Long-term* |
| Compensation | *Money/Equity/None* |
| Involvement | *Catalyst/Facilitator/Committed* |

The operation of each actor is also illustrated by a business concept, giving a basic insight into their action on a very elementary level. It does not purport to be a comprehensive description of the actor's operation, but is rather a subjective snapshot of its basic elements. According to Webster's (1989), a concept is "an idea of something formed by mentally combining all its characteristics or particulars; a construct". Hence, the operating concept seeks to illustrate the groundlaying characteristics of each actor forming its operating logic.

The five categories are not an all-inclusive and complete taxonomy. This can be seen from variations inside each category as well as new emerging variations, some of which are presented later as case examples to illustrate the development of the actors in this arena. Nevertheless, in order to extend our understanding on the future of V2C business models, we must first look at what we have had in this area in past years.

### 3.4.1 Incubator

The National Business Incubation Association defines the function of a business incubator as follows: "Business incubation catalyzes the process of starting and growing companies. A proven model, it provides entrepreneurs with the expertise, networks and tools they need to make their ventures successful. Incubation programs diversify economies, commercialize technologies, create jobs and build wealth". In their Principles and Best Practices they also give the following definition: "A business incubator is an economic development tool designed to accelerate the growth and success of entrepreneurial companies through an array of business support resources and services. A business incubator's main goal is to produce successful firms that will leave the program financially viable and freestanding." (NBIA 2003)

Both of these definitions speak of catalyzing growth, offering resources and services and the latter also hints at the company eventually leaving the incubator. The NBIA talks about "graduates" who "create jobs, revitalize neighborhoods, commercialize critical new technologies and strengthen local and national economies". Indeed, these goals are well in line with the different incubator types, which will be introduced later in this chapter. The incubators differ as to which sides of the graduates they consider to be most critical.

As Aernoudt defines it "a business incubator's main goal is to produce successful firms that will leave the incubator financially viable and free-standing within a reasonable delay". Yet the same author presents a taxonomy with five different main categories of incubators, including technology incubators for overcoming entrepreneurial gap and regional development incubators, which are in most cases political operations, trying to create businesses and jobs in areas which are underdeveloped or undergoing a structural change. Furthermore, the operation may be either a real or a so-called virtual incubator, based mostly on networking with no actual premises for companies to reside in.

Incubators themselves may be non-profit or for-profit organizations, but as pointed out by Paul A. Gompers in his recent lecture to US venture capitalists, most of the hundreds of for-profit incubators established in the US between 1999 and 2000 have had to close their doors. The reasons for this were seen to be limited experience of managers, too ambitious investment plans in regard of their own funding structure and adverse selection of companies, as the incubators only got the see the "bad deals". All in all, it can be concluded that incubator is an umbrella concept (Aernoudt 2002).

**The History of Incubation**

The history of business incubators is considered to have started from Batavia, NY, in 1959, even though there are some prior corresponding activities in some universities. The building, which until three years earlier had housed a vast Massey-Ferguson plant had been closed. It was purchased by the Mancuso family, who wanted to bring life back inside these walls and reverse the unemployment situation. However, they did not find a company big enough to fill the 79,000m$^2$ space alone. As the building needed maintenance and renovations Joe Mancuso decided to divide the building and start renting parts of it to separate companies. His idea – which was completely strange to the contemporaries – included providing shared office services, assistance with raising capital and business advice to the tenants as well. (Adkins 2003)

Within a short time the first companies had moved in: a winery, a charitable organization and – a chicken company. According to Mancuso, it was because of the chickens they started calling the plant 'the incubator' while trying to attract investors and more tenants to the site. Today, Batavia Industrial Center is still in operation. The name 'incubator' stuck long after the chicken company had left, and Mancuso is be remembered as the man who not only started this new industry but also coined the term itself - Business Incubator. (ibid.) Granted that the definition of a 'growth' company has probably changed from those days.

The word itself is much older and has its own history worth mentioning in our context. Asclepius - or Aesculapius as he was known to the Romans - was the son of Apollo and nymph Coronis, and became a Greek demigod. He was a famous physician and healer, and his temples are considered to be the predecessors of hospitals and sanatoria. People with illnesses or other problems went there and stayed overnight in a dormitory for the process of "*incubatio*", hoping to see a dream that could be interpreted by the priests and thus help them to be cured. (Leadbetter 2003, Aernoudt 2002)

Today, the staff of Asclepius with its two serpents is the symbol of medicine. According to the myths he not only considered snakes sacred but also occasionally took the form of a snake. The story also has it that he became too clever in the end when he learned how to raise people from the dead. Zeus, fearing that he might render all men immortal, killed Asclepius with a thunderbolt. (Leadbetter 2003) These translate to modern incubation practices well: companies go to incubators for a certain period of time to get assistance, but an incubator should know when to let go of a firm which is not sustainable. And some for-profit incubators seemingly turned to snakes as well.

**Types of Incubators**

From the start in Batavia in 1959, business incubators have helped entrepreneurs to realize their dreams in the spirit of *incubatio* and tried to keep them alive and well. At first, incubators mostly appeared in the US, but since the mid-seventies they started to occur in the old world, too. These first incubators were mostly bricks-and-mortar (BAM) oriented, offering a limited set of services on top of the office space. Their key incentive was to revitalize declining areas and have new companies take over the plants left empty by closed factories, at the same time creating jobs to compensate for those lost at the same time. (Aernoudt 2002)

In the eighties and rather earlier in the US, a BAM-based so-called *mixed incubator*, hosting all sorts of companies, was not enough, and the focus of incubators turned to fostering the emergence of innovative companies instead of simply filling up empty real estate. The British Steel Industry (BSI), formed in 1975 to create jobs in steel closure areas was clearly an example of the previous category and in fact the first of its kind in Europe. On the other hand, the first incubators in Germany by the University of Berlin in 1983 and in France the Sofia-Antipolis Technology Park in 1985 clearly fall in the second category referred to as *economic development incubators*. (ibid.)

All in all, incubators differ according to their point of origin, funding, profit model, source of incubatees and so on. Besides the Aernoudt study, another recent study also identified five incubator archetypes in line with the forthcoming discussion in this chapter: The university incubator, the independent commercial incubator, the regional business incubator, the company-internal incubator and the virtual incubator (von Zedtwitz 2003). Examples of all these archetypes are presented in this study as noted in the table below.

Table 8: Examples of Incubator Archetypes

| *Incubator type* | *Case example* |
|---|---|
| University incubator | Venture Stables (page 143) |
| Independent commercial incubator | IdeaLab (page 158) |
| Regional business incubator | Batavia Incubator (page 111) |
| Company-internal incubator | NEST of Nokia (page 31) |
| Virtual incubator | EquityEngine (page 153) |

Reflecting the above classification, a new breed of *for-profit incubators* emerged in the late 90's, dedicated to e-commerce and other Internet businesses. Most were private ventures that took an equity stake in the firms they incubated. By mid-2000 there were 150 such incubators in the US alone, but a recent shakedown has dramatically reduced this number. (Skyrme 2001, NBIA 2003)

The most obvious reason for this demise is that the general post-dot.com recession not only reduced the number of incubatee candidates but also blighted the hopes of timely income for the incubator: many of them were building their profit model on exits from client companies in which they held an equity stake. It also seems that many incubators in Europe, too, were merely opportunities for real estate managers and corporate financiers with no sensible business model. (EVCA 2002b)

Another substantial trend in respect of this study are *university incubators*, many of which can also be called pre-incubators. They offer facilities and services, sometimes together with a small grant, to would-be entrepreneurs in need of a safe place in which to explore the potential of their start-up idea. "Venture Stables" hosted by Tampere University of Technology, "Innolinko", affiliated with Helsinki University of Technology, "Institute for Innovation Transfer at the University of Bielefeld" in Germany and "Innovate, Inc." of the University of Waterloo are but a few example of the kind (Yritystallit 2002, Otaniemi Science Park 2003, University of Bielefeld 2003, University of Waterloo 2001). Interestingly, University of Waterloo also participates in the University Challenge Fund program (see Chapter 4.2.6), which at first would appear either to make the pre-incubator redundant or the other way around. As this is not the case, the two models apparently complement each other.

Besides these, another trend was – and is - *virtual incubators* based on a network operating over the Internet. This is, of course, a very cost-efficient way to realize an incubator; virtually no real estate is required, and consultants and other resources can make themselves available on-line. However, this model has drawbacks as well: Having no face-to-face human interaction does not necessarily ease the pain of the embryonic entrepreneurs. Furthermore, the networks may be fairly loose, resulting in lack of commitment among advisors. (Lavrow and Sample 2000)

Outside the classification, there are also other tracks of development. Since the nineties, the trend has been to develop *technology incubators* around specific industrial and technological clusters such as biotechnology, IT, environmental technology or such. Traditional incubators still exist as well, and further variety is brought by the fact that in Europe, for example, the objectives of the technology incubators differ widely between countries. In Belgium and Spain, the focus was initially to attract branches of multinational companies, while in Germany the target was innovative start-ups. In France and the Netherlands the university incubator model was promoted and various initiatives linked to incubators were also taken on the European Union level. (ibid.)

The *Internet incubators* have practically vanished and thus proven to be little more than opportunistic ventures which were put up by real estate companies, bond salesmen, gambling operators or whoever, claiming that they had what it takes to build companies all the way up to IPO. In the worst case, all they had was a couple of conference rooms which were converted into incubator space claiming competitive advantage. In cynical retrospect their assumption was that they could "manufacture" start-ups and then make them public before their success was proven (Davidsson 2002). In fall 2000 the *"networked incubator"* was praised in the Harvard Business Review as "a fundamentally new and enduring organizational model uniquely suited to growing businesses in the Internet economy" (Hansen et al. 2000). Sadly, the dot-com bubble and the operators, being as young and inexperienced as their client companies, failed miserably while work was in progress.

To give some figures on the overall heterogeneity we can refer to the report of the New York Times in January 1999. Of the 550 incubators in the U.S at that time, 45% percent were located in urban areas, 36% were rural and 19% in suburbs. Almost half had had no particular focus while one quarter of them was concentrating on technology, the rest being divided between manufacturing, services or other specific industries. Referring to the words of Geoffrey Moore, while the aim of every incubator should be to give the structure to the bottom levels of basic needs so that entrepreneurs can focus on the higher levels, some of these incubators merely sustain "failed" entrepreneurs. (Benjamin and Margulis 2000) Further criticism can be directed towards the quality of the services offered, as noted by Jonathan Slack of the Association of Business Schools: "Who says that you're going to receive good accounting services, good computing and good accommodation? It's highly unlikely that you're going to get the best deal on any of those things!" (Lindsay 2001)

As a result of the deterioration of the image associated with incubation the companies doing it now tend to call themselves anything but incubators; e.g. *business accelerators*, *venture catalysts* or *e-campuses* (Economist 2000). Even the brightest stars listed on major American stock exchanges, such as CMGI or the Internet Capital Group are trading at a fraction of their peak value, while another promise, Divine Interventures[11], has gone bankrupt after going public. In the promised land of high technology, Israel, incubators are also on the verge of collapse (Feldman 2003), and the leaders of established, in many cases not-for-profit incubators were trying to keep apart from the "new phenomena" incubators which were mushrooming all over the USA. As noted by Barbara Harley, who has established several incubators in the USA and also played a substantial role in starting incubation business in many other countries: "So, now that those same business media have reported the 'death of incubators', they still miss the point regarding the customer-focused growth model vs. the IPO expansion model". (Davidsson 2002)

Nevertheless, business incubation has prospered. There were more than 3,000 incubators in the world in 2000, compared to the 200 twenty years earlier (Economic Commission for Europe 2000). In USA alone, number of incubators was estimated at 950 in late 2001, up from 587 reported in 1998 State of the Business Incubator Industry by NBIA or mere a 12 in 1980 (Linder 2002, NBIA 2003). At the same time they were assisting more than 35,000 start-up companies. Almost half of the total number were still mixed-use incubators, but the share of technology incubators had risen considerably from 25 to 37 percent in just over three years. (Linder 2002)

**Practices of Incubation Today**

Different operating models ranging from BAM to virtual networks and profit models ranging from public and non-profit to equity-based private mean that one definition is no longer enough. And there is no need for one definition, as different types of incubators work towards different ends. But in all cases, looking at the operating methods of incubators, they are based on a formal process and professional activity. Incubating the target companies is someone's main job – not a mere hobby. Therefore, no matter if an incubator is for profit or not, it should be run as a business (von Zedtwitz 2003).

Analyzing the incubator actors we note that whereas for example business angels personally participate as owners in underlying ventures, members of the incubator staff seldom have such personal incentive. Many incubators are public sector based or semi-public actors working under the public eye with little or no space for making mistakes. In this sense, their activity lacks a certain dynamism when compared with business angels or venture capitalists. The employees of an average incubator are paid a monthly salary to do their job, and this does not depend on the success of the companies accepted in the incubator.

[11] The suggested spelling for the company name is divine interVentures.

Much of this job is done for client companies in need of assistance. Most members of the NBIA offer linkages to venture capital and angel investors, marketing assistance, links to higher education resources and intellectual property managers (Linder 2002). To be able to maintain the service level they need to generate revenue, which in most cases is s mixture of several streams: rent, service fees, license fees, product sales, external contracts, sponsorships and equity investments. In order to become self-sustainable, the revenue generation model should have several of these incorporated in its business model. (Lavrow and Sample 2000)

We therefore have look at incubation as someone's business. In fact - referring to our context - many of the incubators are start-up businesses themselves, struggling for their living. Therefore they may be focusing on their own growth instead of that of their clients. This may result e.g. in making compromises when choosing the companies to join the program, compromising their service level and the ideal of synergy among incubatees. Quite the opposite was the target of the Nucleus Group, which put together a group of companies explicitly in order to create synergistic value among them. It coined itself a new breed of incubator, promoting sharing of intellectual resources rather than just physical facilities – the incubatees not only shared the 500 square meters of office space but also assisted each other in e.g. managerial issues, sometimes even having key people multi-tasking between companies. (Vincenti 1994) In an article dating back to 1994, incubators are predicted to be more fashionable in near-term, which according to the current knowledge was an accurate prediction. However, the Nucleus Group praised in the article can no longer be found, illustrating the difficulty of predicting accurately.

The more common criteria set by a technology incubator for acceptance for the companies is in many ways similar to the criteria of business angels and VCs, except smaller in scale then the latter. Companies have to possess proprietary technology, growth potential and exhibit zeal, commitment and experience within the management team. On the other hand, there are also two criteria unique to the incubator industry. First, the company should preferably add value to the incubator and its client companies in the form of networking. Secondly, as the incubator needs to sustain itself, some projects are taken in strictly to generate cash flow. These include for instance companies offering different business services to the clients; while providing services to the incubatees they pay market rates to the incubator for rent and services. (Lavrow and Sample 2000)

While in the incubator, there should be an exit plan from the beginning – at least in the case of a technology incubator. Currently, the average duration of incubation in North America is two and a half years, but the length of the period varies greatly from three months up. The idea behind the rotation, of course, is to make room for new companies to enter. In some cases, the time may even be limited, as in some pre-incubators, or the incubator may wish to speed the process up artificially, in the case of an exit-based profit model. The establishments more spezialized in real estate business and less to development of the tenant companies have the opposite view on "exit"; they want to keep their tenants as their clients as long as possible.

Whether a specific incubator has been successful or which one of the models presented here is the best is not easy to say. As noted by Autio and Klofsten (1998), there are many success stories of incubators and other SME support arrangements, but the actual success is seldom defined. Many of these inspired narratives have been written by a manager of the organization in question or a party close to it, partly motivated by the need to enhance the image of general viability of a particular arrangement. Furthermore, it is difficult to determine how much of this success depends on local factors and to what degree it can be attributed to the management practices of the arrangement. (Autio and Klofsten 1998) There have also been other efforts to set up the performance criteria for incubators and the like (Jungman et al. 2002), and the subject will be discussed later in this study.

All in all, there is an ample amount of literature explaining what it takes to set up and run a successful incubator. Books on the subject can be found by individual authors or incubator associations (see e.g. Rice and Matthews 1995, Gerl 2000), some of which are outdated as they were written during the dot.com era and the basic assumptions have since changed. It is clear, however, that a successful incubator needs entrepreneurs and that these entrepreneurs need seed money. Hence, facilitating entrepreneurship and business-angel networks is important for a society wanting to promote incubators, just as it is important for the incubator to keep good contacts with business angels and other seed funders. (Aernoudt 2002) When analyzing the emergence of the incubation industry in developing countries, Lalkaka (2003) put together the following list of determinants of success in venture creation – the Olympic Rings of venture creation as he calls them:

1. public policy that stimulates the entrepreneurial businesses and provides the business infrastructure
2. private sector partnerships for mentoring and marketing
3. knowledge base of learning and research
4. professional networking, national and global
5. community involvement to promote entrepreneurism and cultural change

Referring to the evolution in the incubation business it is important to note that at the same time as the incubator industry itself shifts towards virtual networks, business advisor services and equity participation, the traditional BAM needs are been taken over by the construction industry. High Tech Centers and Business Parks are being built by the construction companies, who also put together a range of services available to the tenants (Riihimäki and Siekkinen 2002). In most cases these services are limited to functions with regard to the building, such as lobby services, security and cleaning (Hirvikorpi 2002). Business oriented or client-specific services are not organized, and typically clients are not start-ups but more mature companies. The concept resembles that of the original Batavia incubator or the BAM incubators in general.

There are also examples of more established companies subletting some of their space at subsidized rates to start-ups in order to fill the space which is empty either due to layoffs or a long-term lease contract in which the company has prepared for growth. These sites offer substantially cheaper space than incubators but offer no services, which the enterprises would presumably need. (Vaalisto 2002) This must not be confused with the in-house incubators of big companies such as Panasonic, DuPont, Sony or Nokia, which allow start-ups and spin-offs to tap the resources and talents of the host organization, but at the same time may hinder their development with bureaucracy (Economist 2000). The in-house incubators are discussed in more detail in Chapter 2.2.4. on corporate venturing.

Finally, returning to the term "Business Acceleration" mentioned earlier in this chapter we quote Barbara Harley: "All incubators should need to look themselves as accelerators and gather the expertise around them to speed up their clients' successful entry into market" (Davidsson 2002). Also, financing is a key issue for many of the tenants, as their funding has to come from business angels and other seed financiers outside the incubator. Therefore, networking with these parties is crucial for the long-term success of the incubator. One view on these challenges is provided by the eAccelerator, presented as a case example in Chapter 4.2.2.

**Business Concept of a Business Incubator**

As for the business model of an incubator, its basic form is principally an "office hotel" for fledgling companies. Office services are readily available and a variety of business development and support services are easily at hand. Apart from some government grants or rent subsidies - in some cases, some of the services are offered for free or subsidized with public support - incubators do not finance their tenants, but merely offer their services and office space for money. Thus, incubator as a concept is fairly straightforward, although in reality its incarnations come in many forms as we noted in this chapter.

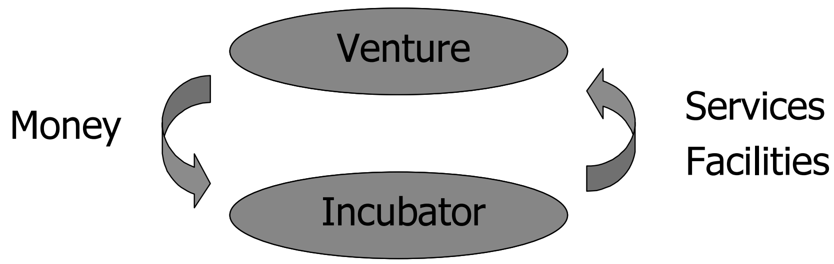


Figure 35. Business Concept of an Incubator

The incubator business model shows that services and facilities are given to the company for money. The time span is medium or long and the organization is a public or private entity. This gives an opportunity for building a good organization to support the ventures. However, there is no mechanism for the client to ascertain for himself the factual skills of the incubator executives. Furthermore, in a traditional incubator there is no vested interest, i.e. long-term incentive such as equity stake neither for the executive nor the incubator, which may result in lack of commitment to the long-term success of the company.

### 3.4.2 Business Angel

As discussed more thoroughly in Chapter 2.2.2, a business angel is an individual with a certain amount of personal wealth and business skills, and willingness to contribute some of these to embryonic companies. The wealth may come from many sources, ranging from own earlier successful entrepreneurship to having inherited a fortune. Due to differences in this group, there are taxonomies differentiating business angels into groups based on variables such as activity, available capital, average investment and focus group (Coveney and Moore 1998, Eriksson and Sørheim 2002, Gaston 1989, Sørheim and Landström 2001).

Accordingly, the amount of capital available to be invested as well as the business skills vary greatly; a successful executive may be willing to invest some of his hard-earned money to get more challenge in his life, bringing in the most favorable case invaluable expertise to the company in his person. On the other hand, a well-off ex-entrepreneur may wish to invest some of the capital earned in the IPO of his company to assist other companies in their early stages. For this business angel, investments may be like bets, but his presence may still provide the company with much more than just money: Prestige, networks and credibility, to name a few examples.

Nevertheless, the business model of a business angel is quite simple: They invest money in early stage ventures, and in return they receive an equity stake, hoping to get their investment back with profit. Besides the “normative VC exit routes” of trade sale and public listing, the profit scenario of a business angel also includes other alternatives, such as sellback to the entrepreneur, selling forward to other investors or keeping the stake and collecting dividends. Thus, a business angel is prepared for a relatively long investment time span.

To achieve his goal, a typical business angel is willing to contribute some of his time to the company as well. This work is typically non-operative, like board work or screening for potential VC investors, but operative work is by no means exceptional: interacting with or even being a member of the management team, assisting in marketing planning and implementation of the plan, lobbying for clients through own networks and so on. Only in rare cases is the angel paid for these services. The caveat is that it is not easy for the entrepreneur to know the value and quality of these services beforehand. In other words: it is not easy to judge the quality of the business angel when looking at the investment proposal. Not that the angel could be sure about the quality of the company he is considering to invest in, for that matter.

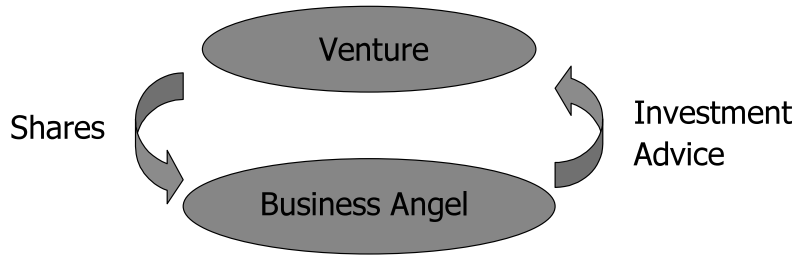


Figure 36. Business Concept of a Business Angel

A simplified business model of a business angel can be seen in the above figure: In return for the equity stake given to the angel, the company receives capital investment and in most cases a certain amount of advice and work, either consultative, operative or board work. As the angel is an individual, the form of operation is informal and in a sense “unorganized”. Still, the commitment level is high and time span long due to the vested interest.

### 3.4.3 Business Angel Network

As noted in the discussion regarding business angel financing, a major problem in the development of the business angel investment market is their desire for privacy. As long as the individual investors are not listed in the Internet or public directories in the same manner as banks or venture capitalists, they cannot be reached. From the entrepreneur’s point of view the problem is clear and evident: To find the business angels.

Several efforts to solve this problem have been made. There are – usually regional - matching portals such as the US-based Investment Exchange and Technology Capital Networks, the eForum planned by EU (eForum 2001) or the Intro service in Finland, described in Chapter 4.2.9. Also, in many countries and regions, venture fairs are organized either at regular intervals or in a more haphazard manner. (Benjamin and Margulis 2000) The most established connection between the ventures and business angel investors, however, are the Business Angel Networks, or BAN for short.

A BAN is defined as an organization whose aim is to facilitate the matching of entrepreneurs (looking for venture capital) with business angels. BANs tend to remain neutral and generally refrain from formally evaluating business plans or angels. A BAN makes a marketplace for matching services. (Saublens 2000) Even though matching is presented as the primary function of a BAN, it also serves other purposes e.g. by educating both investors and potential target entrepreneurs about private investments, lowering the barrier for new entrants to start investing and enabling co-investments, i.e. syndication. Still, it is evident that the main focus of the BANs in general is to overcome the matching problem, or matching gap discussed in chapter 3.2.3.

By now, BAN is an established phenomenon. Numerous business angel groups are in operation in the US, some of them very powerful when measured by the amount of capital provided to investees (Benjamin and Margulis 2000). There is even a directory of BANs and Venture Capital Networks (Teel 1999), perhaps trying to be to the informal venture capital what the Pratt’s Guide (Pratt 2002) is to the formal venture capital market. Regarding the old world, Europe has its own association for them called the European Business Angels Association, and tens of European countries have a national BAN association with a talent pool available at least in theory to help potential promoters of regional informal venture capital networks such as BANs (Saublens 2000).

Most, but not all BANs have their own staff (Saublens 2000, Suomen Businessenkelit 2002) for resources are needed for pre-screening and pre-processing the investment opportunities and take care of various administrational duties, including organizing the usually monthly meetings of network members. Ease of membership and investing is important to the members, and camaraderie and schmoozing may be just as important reasons for membership as financial rewards and opportunities (May 2002). There is a membership fee to cover the costs of the services, and usually the applicant companies are also charged for being exposed to the network (Lindsay 2001, Abernethy1995).

**Diversity of Business Angel Networks**

The orientation among BANs are numerous and they may be either public or private (Abernethy 1995). Some are merely small groups of investors called “venture capital clubs“, sharing information and sometimes pooling the investments, while others are more organized matching services to serve a client base of astute informal investors. One basis for their creation is the reluctance of the so-called “investment clubs” to work with people wanting to invest in other than publicly traded stock. The 100 to 150 venture capital clubs in the US typically have 12–25 members, usually some of which are more affluent, seasoned angel investors who serve as mentors for others. (Benjamin and Margulis 2000)

At the other end of the BAN spectrum from these hands-on investors are the computerized or even net-based matching networks utilizing the possibilities of modern technology to overcome the challenges in matching and anonymity. These portal-approach actors include for instance the MIT Technology Capital Network and Investors Circle in the US and VentureNet in the UK (Mason et al. 1996, Benjamin and Margulis 2000). One categorization divides the portals into three classes: 1) collection of regional angel alliances; 2) matching network or business introduction service; and 3) electronic matching network (Sohl et al. 2000). Taking into account the publishing date of the categorization the third category appears ancillary, as the other two can hardly do without the use of electronic databases either. Nevertheless, the study it is based on explores the differentiating factors between the different types of business angel portals and networks, and reveals their inherent diversity.

This diversity is also evident when examining the survey conducted by Van Osnabrugge and Robinson (2000), who list reasonably detailed information of more than 70 US-based matching services. They divide these organizations into four plus one categories: 1) Formal matching services; 2) Groups of angel investors (angel alliances and syndicates); 3) Breakfast and luncheon groups of casual investors (venture capital clubs and forums); 4) Internet-based matching services; and 5) Others. To add to the diversity of their analysis, the list also features a number of other types of beneficial service organizations, such as business incubators and seed-stage venture capitalists.

Hence, it can be seen that the paradigm of BAN is changing and developing over time. As proof of this, four enlightening case studies of “successful angel portals” as quoted in the editorial (Sohl 2002) can be found in a special issue of Venture Capital based on “The State of the Angel Market” conference held 2002 in Boston (Cerullo and Sommer 2002, May 2002, Payne and Macarty 2002 and Pollock and Scheer 2002). Still, being innovative or using the latest and greatest computer technology alone does not make a BAN. The most important factor is that there are individuals willing to invest their money and – hopefully – contribute the expertise they possess to the development of fledgling companies on the verge of growth and success. The importance of people can be seen when comparing a well-established BAN in California, Band of Angels, with the BAN tryouts in the less developed business angel atmosphere of Finland.

Since its inception in 1994 the Band members have placed more than $110 million in more than 140 companies, six of which have gone public and sixteen have been acquired. The members are founders or former executives of substantial high-technology companies, and it is noted on their website that “start-ups receiving funding from the Band can count on also receiving board members, business advice and business development contacts from these very well connected and experienced individuals”. To cater for the subsequent needs of portfolio companies, such as bridge financing and follow-up rounds, the Band of Angels also has a $50 million venture capital fund, comprising funds raised from institutional investors. (Band of Angels 2003).

In contrast, the Finnish business angel association was first established as the Business Angel Association of Western Finland. It dropped the word Western from its name to address the whole country. Apparently, as there were so few active business angels available, the operation was and still is run by an outside contractor, the business development agency Ledi. The operation is supported by several government and private entities, the main contributor being Sitra, a state venture capital organization. Unfortunately, Sitra also hosts a fairly similar service of its own (see Intro service in Chapter 4.2.9), resulting in little interest in developing this more informal business angel network. Hence, the sole distinguishable BAN in Finland is suffering both from lack of resources and lack of investors. Other than that, the operating principles and objectives expressed on the website of the association (www.ledi.fi/bisnesenkelit/) were very similar to those of any BAN, including those of the Band of Angels. (Suomen Bisnesenkelit 2002)

Quite the opposite kind of of problem was identified in the UK, where the large number of BANs made the informal investment market too fragmented to serve the investors and ventures well, as none of the networks achieved critical mass. Further critique arose from the lack of quality control in the opportunities presented to the member angels; after all, BANs are not regulated by any means and despite the efforts of many of the national BAN organizations in Europe, codes of conduct vary widely between BANs (Saublens 2000). The ineffectiveness of matching mechanisms used, faltering co-operation between public and private sector as well as jealousy over quality deals has also damaged the operations of business angel networks. (Mason et al. 1996)

**Practices and Principles of BANs**

There are undisputable benefits and opportunities in BANs. They are essential in facilitating the matchmaking between source and demand for informal investment capital. Furthermore, the fact that in business angel networks the deals usually come in prescreened lowers the barrier for investors. The actual due diligence will eventually be done by those who are interested in investing in the venture after the initial presentation at the member gathering.

As an example of a pre-screening method, the process used by the San Diego Tech Coast Angels can be presented. The applications are submitted by candidates using a standard application supported by appendices. Four to six pre-assigned members meet every three weeks and rate the applications using the system presented in Table 9 below. The best applicants are scheduled for a Screening Meeting. Applicant companies are contacted after the network pre-screening meeting and provided with feedback on their plans. About 35% pass the process, most of the rest being rejected as not being ready for investment. (Payne and Macarty 2002)

Table 9: The pre-screening point system of San Diego Tech Coast Angels (Payne and Macarty 2002)

| *Variable* | *Max points* |
|---|---|
| Management team | 25 |
| Market opportunity | 15 |
| Market need | 15 |
| Product or service | 10 |
| Competitive advantage | 15 |
| Valuation | 20 |

Every three weeks the surviving plans have a chance to make a 30-minute presentation to the members, followed by private discussion trying to identify "champions" for the deal from those who are present at the meeting. In the case of a positive outcome, a due diligence process will be started. If at least one of the investors agrees to invest in the company after the due diligence is completed, the case will be presented to the network again to solicit more investors. It may also be presented to other networks to increase the probability of fully subscribing the investment. The whole process is agreeably arduous, but the alliance views it as a qualification process. (ibid.)

All in all, informal investments are becoming an increasingly popular and important vehicle in financing new enterprises, amounting to a conservative estimate of ten times the amount of formal venture capital. This together with the developments in information technology, in particular the Internet, are creating a new world of opportunities for business angels and their networks. BANs are taking full advantage of these opportunities and the resulting wave of "introduction services" is gradually taking angel investing out of the closet by generating deals more efficiently, distributing information about private equity activities and reducing the informational and search costs associated with the old "atomistic" format of angel investing. Still, little is understood of the key success factors of BANs in the 21st century. (Leleux and Surlemont 2000)

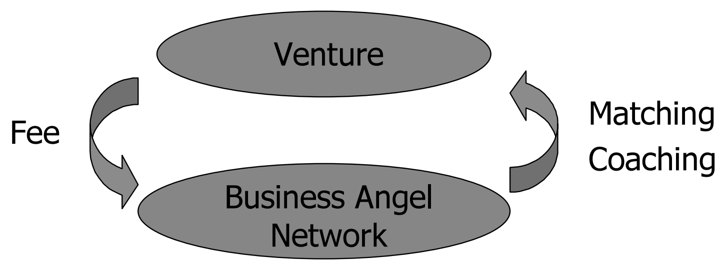


Figure 37. Business Concept of a Business Angel Network

Basically, the business idea of a BAN is fairly straightforward, no matter which kind of BAN it is. It collects a fee, for which the company gets certain amount of exposure to the members of the BAN. In some cases the company is also coached to make it more prepared for the meeting with investors, but the consultation is limited to this only. The actual work with target companies consists of short-term one-off transactions, in which the network acts as a catalyst, facilitating the investment between its "client parties".

### 3.4.4 Advisor

In industry analyses, three things persist as the most common mistakes leading to failure: deficient or non-existing marketing; bad or lacking financial control; and not taking advantage of outside experts and consultants. Also, the bigger the company, the more it uses outside advice, although it would appear that the opposite would make more sense. (Almgren and Lindfors 1996c) In the best case, these short relationships are what it takes to launch the venture to success, to differentiate between make and break.

Therefore, advisors are the fourth group of Venture-to-Capital to be analyzed in this study. Business development advisors – or consultants - working with start-up companies may be either individuals or consulting offices, private or public. It is their job to assist companies, for which they receive monetary compensation. Compared with business angels and incubators, advisors are focused on their own short-term gains and profitability and typically involved with a given venture for a shorter time (Seppä and Näsi 2001). Advisors are highly skilled and motivated professionals who have seen many cases and can derive advice 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 a fund-raising effort.

In a broad context, advisors could be compared to the *Knowledge-Intensive Business Services*, or KIBS for short. There is no established definition for this term yet, but in general it consists of providers of business-to-business services where knowledge is either created or used to provide professional services to – as B2B already says - mainly other companies. When initiating the term, Miles among others divided these “professional services” into users of new technology - such as marketing, insurance, private equity and accounting - and those based on new technology – such as software, IT services, telematics and various design and assistance services using new technology. Services outside KIBS included health, mail and delivery services, entertainment and public administration except business support services. (Kautonen et al. 1999, Miles 2001)

In the sense of using technology this classification seems slightly outdated or artificial today, as for example courier companies, health services and entertainment are all heavy users of knowledge and technology, and many private equity companies – for a good reason - trust their instincts more than technology. Still, the four-faceted requirement for KIBS is fairly valid and the classification only shows the vast variety of services and business services available. But of these, this study is only interested of those actively contributing to the development and growth of the company instead of merely offering services. We might say that the advisors we are interested in are those, which make the difference.

**Qualities of an Advisor**

Advisors make the difference in the sense of actively assisting the company to succeed instead of failing, and they also differentiate their services for each client. A software provider or accountancy firm gives the same service or product to all of its clients, whereas a highly competent business angel or auditor is able to actively improve the clients’ chances of success. This resembles the so-called Kano Model, concept of two dimensions of quality developed in late 1970s (Kano et al. 1996), which is basically an extension of the better known motivation-hygiene theory (Herzberg 1959). According to the model, the quality parameters of any product can be divided into two: the Must-Be Quality and the Attractive Quality. In the case of a car, a heater and a reliable motor belong to the former group, where as air conditioning and powerful motor belong to the latter, forming attractive elements for the product. In our case, KIBS such as lawyers or software can hardly be expected to be the key to success, although they are necessary for the fluent operation of the venture. On the other hand, prominent management consultants and public business development services are more or less expected to actively contribute to the outcome – the success of the client.

As noted in a best practice summary for a small business consultation manual - funded partially by the European Union - microcompanies with less than five workers need explicit advice instead of large analyses, and putting the advice into effect should often be the responsibility of the consultant as the entrepreneur seldom has time to do the necessary work as he is – and has to be – concentrated in doing his business (Routamo and Hotanen 2000). This is the proverbial "too busy sawing to sharpen the saw" situation.

On the other hand, at worst, an advisor relates to quick-and-dirty, get-the-money-and-run type operation (Seppä and Näsi 2001). Advisors are sometimes blamed for not caring what happens in the client firms once their assignment is finished, and for true usability of the data or work they have delivered for the entrepreneurial team to use. As another proverb says: "Shall we mess it up ourselves or do we use a consultant?" (Almgren and Lindfors 1996c).

Advisors certainly work under market pressure, under pressure for 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. This raises an ethical question whether he will give advice leading to the end of the business, or purposefully lead the relationship towards more business (Bearden 2003). Hence, the integrity of the advisor is crucial and the only right answer is to put one's trust in good work leading to more business, no matter how naive it may sound.

**New Ways of Advising**

Advisors are also changing and their methods developing. First of all, to address the ethical issues concerning fees described above, many are basing their fees on deliverables or results, rather than time and material. This may in fact bring more revenue to the consultant, as much the material can be re-used. Second, to make the advisor more committed and care about the long-term success of the client, part or all of the fees can be given in the form of an equity stake. (Skyrme 2001) We can also note that many certified public accountants or auditors in general take a more active role nowadays, transforming from "corporate cops" to business advisors and strategists (Goldstein 1996).

As computerization and Internet provide new opportunities for knowledge management, there are also new ways for advisors to organize themselves and do their work. Many kinds of on-line services have been built around the established consulting companies or from scratch by individuals, combining the knowledge of large number of experts on-line. A few examples are given in the following:

KMPG teamed up with MatchCo to offer online advice to entrepreneurs. For a fee of £1,000 an entrepreneur can have his ideas evaluated, obtain advice on financing, marketing and legal issues. MatchCo helps match the venture with investors, while KMPG consultants give advice on presenting the business case to them. At KMPG this is considered a new way of delivering consultancy and gaining Internet based clients. (Skyrme 2001) At the same time, MatchCo acted as a "digital incubator after such Asian predecessors as techPacific and AsiAlliance, providing support in business plan refinement and matching fledgling Netpreneurs with financiers for 5% of equity" (Time Canada 1999). Unfortunately, the UK-based MatchCo suspended its services in early 2001, after just two years on-line (MatchCo 2003).

EquityEngine, called itself an automated virtual incubator, but one of its unique features as such was its capability and aim to connect ideas to a vast amount of resources. People registered as *Visionaries* providing ideas, *Resources* offering services for them and *Investors* willing to invest in possible new ventures. The idea was to expose the incoming ideas to the resources and whether they first of all saw it viable, and if so, which ones of them would be willing to act as advisors for the company with an equity stake as a reward. EquityEngine made room for many kinds of resources, including advisors working on their own or in larger companies. Thus, from the advisor's point-of-view, the mechanism was a new way to find and select customers. (Bray 2001, interview Stucke) Sadly or not, EquityEngine also went out of business in the fall of the dot-com era, as can be seen in the case description starting from page 153,

**Contemporary Challenges of an Advisor**

Despite the development and effort of the consultant business, there is criticism from the investor community of the quality of early stage support provided both by private and public business support organizations. As articulated by a Scottish seed capital investor, finding advisers with the necessary skill to bring the business plan up to an acceptable level has proven to be very difficult. Just a few public sector advisers are prominent in preparing ventures to investment, and many plans prepared with the assistance of professional advisors are rejected as they do not stand up to scrutiny. One reason for this is that the company is a client for the advisor, who therefore wants to avoid conflict arising from assertive doubts. (Mason and Harrison 2002a)

An interesting notion can be derived from those of Bergholz and Nickols (2000), who stated that independent consultants needs three skill sets:

- Skills in the area of technical expertise
- Skills required from all consultants; writing proposals, client relationship management, diagnostic interviewing etc.
- Skills in managing a small business

They note that consultants are usually weakest in the third issue, and therefore make bad entrepreneurs. Just like the engineer who fails in a managerial position because he was promoted primarily for his technical competence, many independent consultants are more keen on their technical expertise than on the entrepreneurial front. Illustrative to this is the fact that most failing independents choose to stay in their technical fields and work for someone else, whereas entrepreneurs in general consider the type of business secondary. (Ibid.) An interesting notion is that the independent advisors working with start-up companies should be well aware of all the issues concerning small business management, both their own and that of the client.

To summarize, advisors may be individual consultants or consultant companies. They offer various services for money: market research, exporting, writing business plans, raising capital to name only a few. They are generally professional and entrepreneurial in what they do, delivering good quality advice for different situations. Naturally, actual results may vary as not all advisors are equal, and none of them is an expert in every issue facing a start-up venture.

Like incubators, they provide no funding but on the contrary require immediate monetary compensation for their services. Therefore, unless the target venture is backed up with good amount of "friendly money", it has to find a source for financing. Raising capital may happen through an advisor offering this kind of services. Advisors are also often called in by other V2C players and vice versa. Therefore, networks are crucial for the added value and long-term success of an advisor.

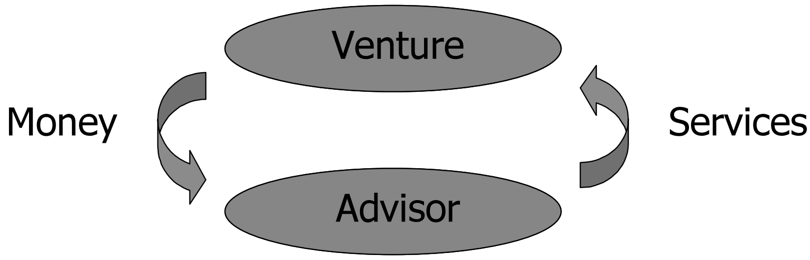


Figure 38. Business Concept of an Advisor

In general, the advisor provides the client with advice on a specific issue for money. Concentrating on one area of development, the approach is seldom holistic. Also, the work is short-term by nature, as it is usually project-based. Board work would give the advisor a certain amount of long-term commitment and a holistic view, but advisors are rarely seen on the boards of their client companies. All in all, an advisor is a professional working with a client, not an owner looking after his possession.

### 3.4.5 Seed Venture Capital

Venture capital as a business model is nowadays fairly well established, as discussed in more detail in Chapter 2.2.3. In the most common – perhaps even normative – model, a managing partnership puts together a fund, into which investors put their money for certain period of time, expecting it to be returned with profit later after the fund matures, i.e. expires. The fund is managed by the partnership, who tries to make profitable limited-time investments in unlisted private companies. The partnership gets its income from an annual management fee of a percent or two plus a share of the profits they gain, usually after a minimum agreed beforehand as the so called hurdle rate.

There are variations to this *limited partnership* model, in which the investors are limited partners and giving more or less *carte blanche* to the managing partners. The most notable variation is the original one-company model, where the funds are invested from the balance sheet of the VC company. This model is used e.g. by state-owned VC companies in undeveloped VC countries and many corporate venture capital funds, but also VC players like 3i, listed on the London Stock Exchange, follow this model.

Currently, the private equity market has shifted away from this model towards more capital-intensive later-stage investments, and many actors in this field are more private equity managers than venture capitalists in the classical sense. Still, the seed VC companies operate according to the classical VC model, which is the most traditional model of venture capital investment. Part of corporate venturing works this way as well as discussed in Chapter 2.2.4; typically large and middle sized corporations have their funds for spinning off internally born business ideas, which do not quite fit their own core business but are still too valuable to be left unexploited.

There is no definite limit to where venture capital ends and private equity investment starts, or definition differentiating seed venture capital from venture capital. Seed capital itself is defined as the initial capital for a start-up venture usually provided by the founders, friends and relatives a.k.a. 3F's, but may also be provided by seed venture capital firms (European… 2000). As seed investments are those made to small, young companies with high growth potential, we might rely on the definitions in connection with new ventures to have a quantitative definition. Unfortunately, defining seed investments as those made in growth companies with less than 50 employees, €10M in sales and eight years of age is too broad, covering a good number of start-up and growth investments as well.

Therefore, we will make do with a qualitative definition based on investment rounds and operational stage of a company. One definition sees seed stage as the first stage of the venture, being in idea stage or in the process of being organized, after which come the research and development phase and eventually the start-up phase (Benjamin and Margulis 2000). Another way to look at this is to see the idea phase as the concept stage, followed by the seed stage when the ideas are refined and a more detailed business plan written for the start-up funding round (Bell and McNamara 1991). Generally, seed capital is provided in order to develop a business concept before a company is started (European… 2000).

Combining these definitions we conclude that seed venture capital investments are made into promising ideas and ventures in their organizing stage to fund their way towards the start-up round financing. This, in turn, will be provided by venture capitalists with the aim of utilizing the growth potential of the firm and eventually making it reach the upper limits of a small company.

Typical attributes in this model include long investment span, high upside potential and risk, immaturity of target company requiring lots of attention from the investor and relatively small amount of equity required. These factors – risk, attention, small investment size - bring in the effects of equity and competence gaps discussed later, discouraging many mainstream VC players from investing in the early stage companies (Rasila et al. 2002). Nevertheless, entering the target as early as possible brings most upside potential for the exit phase.

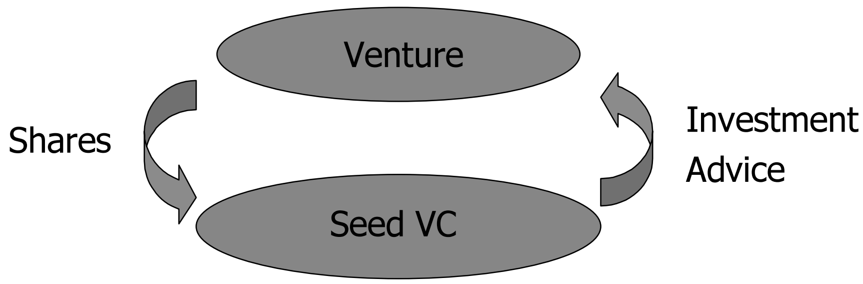


Figure 39. Business Concept of Classical Seed Venture Capital

The business model resembles that of a business angel in many ways, but in this case the actor is either a public or more commonly a private entity managing a fund in which other public and private parties have invested. It is professional in the activity in question, with networks and advice as a substantial contribution in addition to money. Networks may be more formal, international and defined than in the case of business angels. Advice is in most cases limited to board work and assistance in special situations such as recruiting top executives, raising capital and crisis management. As in the case of venture capital in general, the actor is committed to the success of the company with a vested interest in the form of equity stake, and in case of seed venture capital the anticipated time span is generally long.

### 3.4.6 Characteristics of Traditional V2C Actors

We can summarize the findings of this chapter as follows:

- *An Incubator* is usually a public entity, sometimes private, charging monthly for its services. Its primary business is selling the venture its services, facilitating the success of the venture.

- *An Advisor* may be either a private individual or a private or public party, charging for its services except in the last case, when the services may be subsidized as they are offered because of social interest. Advisors act as facilitators with no commitment, having a time span limited to the short or medium term.

- *A Business Angel* is a private individual by definition, investing his own money in the venture. This means that the actor is committed to the success of the company and is looking for long-term financial returns through exit or other returns.

- *Seed Venture Capital* actors are legal entities, usually private, investing other parties' money inside the venture. Like business angels, they are committed to the success of the company and looking for long-term financial returns through exit.

- *A Business Angel Network* is a formal or semi-formal organization, sometimes public if no private organization exists. Its role is to be a short-term facilitator of investments in ventures by business angels, for which it receives a one-time monetary compensation as a fee.

In order to analyze and compare the five classes of V2C actors, the parameters defined in Table 7 are used to make a comprehensive presentation of their characteristics. The results are shown in Table 10 below.

Table 10: Characteristics of Traditional V2C Actors

| | *Establishment* | *Organization* | *Source of Money* | *Direction of Money* | *Interest* | *Time span* | *Compen-sation* | *Involvement* |
|---|---|---|---|---|---|---|---|---|
| Incubator | Public/Private | Entity | n.a. | Out | Business | Medium | Money | Facilitator |
| Advisor | Private/Public | Individual/Entity | n.a. | Out | Business | Short/Med. | Money | Facilitator |
| Bus. Angel | Private | Individual | Own | In | Financial | Long | Equity | Committed |
| Seed VC | Private/Public | Entity | Others | In | Financial | Long | Equity | Committed |
| BAN | Private/Public | Entity | n.a. | (Out) | Business | Short | Money | Facilitator |

Looking at the first parameter we note that it is not easy to put a label to an actor, as many of them may be public, private, or public-private partnerships. It could be argued that this parameter has no importance, as all actors should be deemed equal and even the public actors should be able to operate financially self-standing to be entitled to exist. This is not always the case, however, as due to social reasons many actors, especially in developing areas, are public, since no private entity would survive. Whether this plays a role in quality of the V2C actor is another question.

From the financing point of view, there are two completely opposing pairs within these four: business angel and seed VC, who bring money in, and incubator and advisor, who take it out. These pairs also differ in availability: incubators and advisors are more generally available, whereas business angels tend to keep out of sight, and both they and seed venture capitalists are more scarce resource to begin with. Looking at the above table reveals that the five last parameters are associated with these pairs and can be reduced to one. In short, taking equity as compensation brings commitment and makes the actor interested in long-term financial returns instead of short-term business.

Therefore, in Table 11 we reduce these into a parameter called "Commitment", in which the actor is either *committed*, referring to taking an equity stake and hence sharing the risk, or *paid for*, referring to being paid for the assistance provided. On top of those used above, there is a multitude of other parameters that could be used to compare the actors: added value, availability, reachability, level of networking, scope of work, quality of skills and so on. These parameters are vague and would show even more variation within each class than those used, rendering them useless in the present context.

Table 11: Refined Characteristics of Traditional V2C Actors

| | *Establishment* | *Organization* | *Source of Money* | *Commitment* |
|---|---|---|---|---|
| Incubator | Public/Private | Entity | n.a. | Paid for |
| Advisor | Private/Public | (Individual/)Entity | n.a. | Paid for |
| Business Angel | Private | Individual | Own | Committed |
| Seed VC | Private/Public | Entity | Others | Committed |
| BAN | Private /Public | Entity | n.a. | Paid for |

All in all, even in this form the classification appears ambiguous. It is not comprehensible in the sense that many actors have substantial variation within their group. Also, comparing the groups with each other is futile, as the groups serve very different purposes and have completely different goals. The only thing common to all of them is that they are within the reach of new ventures, and that providing added value to these ventures is the reason for their existence, regardless of the motivation.

We can therefore conclude that there are probably still too many parameters in the classification as the groups are heterogeneous, and too few classes as all actors do not fit fluently into a distinct class. It can be argued that one reason for this is the development in the marketplace, which has differentiated the actors from the established *de facto* business practices of their kin and hence from each other. Also, there are new actors, which are also available to assist the new ventures but do not fit the classification presented.

We will now look at a number of these new, emergent V2C actors, some of which are close to existing ones while some of them are more innovative. Our target is to assess the validity of the prevailing taxonomy based on the findings and improve it if necessary to better reflect the reality. Also, the findings can be used to improve the practices of the prevailing V2C actors presented in the foregoing, creating new, more efficient V2C practices and actors.

# 4 EMERGING MODELS OF VENTURE-TO-CAPITAL ACTORS

*"Anyone who has never made a mistake has never tried anything new." – Albert Einstein*

In this chapter, the operating models of emerging Venture-to-Capital actors are analyzed using multiple case study as the research method. The findings will be assessed and compared together with the prevalent models analyzed in the previous chapter in order to modify and improve the theory of Venture-to-Capital by creating a more relevant categorization of actors in the V2C arena.

## 4.1 Need for New Venture-to-Capital Practices

We have noted the importance of small and growing enterprises in creation of jobs, innovations and wealth earlier in this study. Studies about New Technology-Based Firms (NTBF) and Venture Capital show that both the supply of good start-up companies and supply of capital to fund these ventures is vital to success. Still, despite the general availability of funding and several types of actors for aiding fledgling companies as depicted in Chapter 3.4, many promising ventures fail before reaching any success.

There are many reasons for this, and of course, not all companies are fit for success anyway in the first place – just as some will always persist and succeed, regardless of the hardships they encounter. But those which fall in between are often victims of the three market imperfections identified earlier: Equity Gap, keeping them out of the scope of VC financiers; Competence Gap, hindering their possibilities to get the assistance they need; and Matching Gap, separating them from informal investors which might provide them both financing and competence they are in need of.

There are also two other, more general problems in the V2C arena. First, the arena is badly unorganized. Second, the actors in it are very heterogeneous. This is evident when compared to e.g. venture capital companies, which despite their different investment strategies are still a fairly homogenous group with known business principles and usually a national central organization. As a result, an embryonic entrepreneur seldom has enough knowledge and understanding about the available alternatives to make a well-informed decision when choosing the right partners at the V2C stage. And the decision may affect the entrepreneur for many years.

Of course, traditional V2C actors try to solve these problems, each one having its own approach to the issue. As discussed earlier, seed VC's and business angels endeavor to provide financing and some expertise along with it, while advisors concentrate solely on the latter. Business angel networks try to match ventures with business angels, but provide little more added value to the venture than that. The role of incubators is centered in providing services and facilities to the entrepreneur to make the initial steps easier.

None of these actors is even trying to be an all-inclusive solution to the problem of three gaps. Additionally, according to our findings in Chapter 3.2, the market they form operates inefficiently, leaving many capital and knowledge needs unsatisfied. Therefore, the market and its clients – the ventures – would benefit if there were other operating models for actors assisting them. These improved models might cross all the three gaps at once, but even a partial solution could provide substantial improvement to the present situation, hopefully resulting in more successful companies and hence more jobs and economic welfare.

## 4.2 Field Study on New and Emerging V2C Actors

The world is – and has always been – in constant change. Similarly, requirements and practices in the Venture-to-Capital arena have changed over time, and new business models have been created within it. One of our goals is to find out what kind of change is required from the V2C actors to adjust to the changes happening around them, in their operating environment. We approach this question by looking at the changes already happened: the operating models of new kind of V2C players.

According to Darwinism, time will tell which of traditional and new models will survive. New variations may pick features from several other models, adding something new, and try the combination out in the marketplace. In time, this will prove the viability of the model: if it serves the venture and economy in general, it is bound to succeed and have imitators. This, of course, assumes a perfect world, competition and economy, but it is the best we can do.

In the following, a heterogeneous selection of case examples of these new actors is presented. The selection of examples is based on an effort to make this study interesting and thought-provoking as well as scientifically reliable and valid. As noted already on page 9 in discussion on methodology, the comparison method applied to choosing the case examples is known as theoretical sampling, calling for choosing cases that represent different aspects of reality (Glaser and Strauss 1967). It is an ongoing sampling process in which the researcher simultaneously collects, codes and analyzes the data, making decisions on where to collect the next sample based on the earlier results. The cases were chosen because of suspected differences between them (Gummesson 2000), and the sampling stopped when saturation was achieved, i.e. the marginal contribution of each additional case approached nil (Glaser and Strauss 1967). Therefore, we will look at the following fourteen case examples, each one of them having at least one unique factor in their business model:

- Trial Marriage of LINC Scotland, a business angel network catalyzing due diligence
- Virtual CEO, a business angel who does not invest money but time
- Source Code Finland, investing "sweat capital" for equity compensation
- eAccelerator, boosting fledgling companies with money and advisors
- UK Venture Capital Trust, channeling funds from public capital market to small companies
- University Challenge Fund, enhancing university spin-offs
- Venture Stables, a pre-incubator giving innovations a free push within the university
- Liksa, a public incentive for pre-seed development
- Intro, a matching service with both on-line and live action
- Diili, mating experts with start-ups to join their entrepreneurial teams
- Entre Nous, providing mentors for young entrepreneurs

- EquityEngine, an automated virtual incubator matching all resources on the internet
- Privanet Capital, providing investment banking services and brokerage for SME's
- Idealab, a VC Bootcamp or internet incubator

As can be seen from the short descriptions above, there is substantial variation between the V2C actor models and scopes of operation. Also, during the past few years, new models and combinations of earlier ones have appeared on the market; advisors who accept or even require shares as partial payment for their services; incubators who invest in a company and make a profit-sharing incentive plan for the pay-back period; business angels who organize a fund for individuals; and a secondary market place for unlisted, high-risk shares.

Information was collected using several methods. The most productive sources of information were the websites, marketing information and press releases provided by the operatives themselves, together with news articles published in magazines, newspapers and on-line publications. For some there were also academic articles or other literature available. In nine cases the survey was also supported by one or several interviews to find out the latest information, check the existing data and fill the gaps in the information. The interviews are listed on page 202. This multi-faceted approach in gathering information about the reality is supported by the literature on qualitative methods (Glaser and Strauss 1967, Arbnor and Bjerke 1997, Gummesson 2000).

Our task in the following is to assess the operating models of emerging actors in the growth venturing arena and compare them to the models of prevalent actors in order to create contemporary taxonomy of actors. In analyzing the case examples, the underlying question is: Are there new practices which would enhance the operation of the V2C actors, and do we need a new breed of players to implement them? The results are summarized at the end of this chapter and implications discussed more thoroughly in the subsequent discussion in Chapter 5.

### 4.2.1 "Trial Marriage of LINC Scotland" – Catalyzing Due Diligence

As noted earlier, when talking about the mismatch between early-stage ventures and early-stage financiers, we must look at the problem from both sides. It is known that the supply side in the venture capital market has constraints, having shifted to later stage companies and sometimes posing unrealistic expectations to entrepreneurs with little to give back other than money. On the other hand, the demand side is not perfect either; new ventures are far from being ready for investment (see more about investment readiness on page 102) and the screening process takes time from the potential investors especially when the target is still unorganized, working *ad hoc* day to day.

The Trial Marriage program was started in 1998 to interest business angels in exploring ventures, which seemed to be interesting but needed to be worked upon to become more investment-ready. The program was partially funded by the European Union and operated by LINC Scotland, one of the oldest and most active business angel networks in the UK. The word LINC is an acronym from Local Investment Networking Company, which is the name used in the UK for a kind of independent nonprofit offices residing in many cities in pursuit of matching local investors and ventures in need of capital (Suomi and Lumme 1994).

Quite simply, the idea of the program was to pay the angel so that he would work for the company as a consultant for up to 15 working days. After this he could then make his investment decision. If the decision were positive, the support would be paid back to the program since the business angel was then effectively working for himself by making due diligence, or for the company receiving the funding. In case of a negative decision, the company would have enjoyed for 15 days of subsidized consulting. (Mason and Harrison 2002a)

The program was active in 1998-99 and was re-launched as the Investment Facilitation Grant in December 2001 with more active operations after August 2003. The most substantial differences in the revised program are that a slightly raised amount of support is paid to the company instead of an investor, and that in case of an angel investment the grant can be converted to equity on the same terms as the main external investors, giving upside potential to the income. This is seen by LINC Scotland as an important alternative for funding the program, which is initially heavily dependent on public funding. The budget for re-launching the program is £150k per annum, which is equivalent to £240k when the portion of companies and sponsors is added. As not all support is expected to be at full cost the target is to support twenty companies per year. So far, ten grants have been made or committed, and enquiries are coming at a rate of two per week. (Mason and Harrison 2003a, 2004)

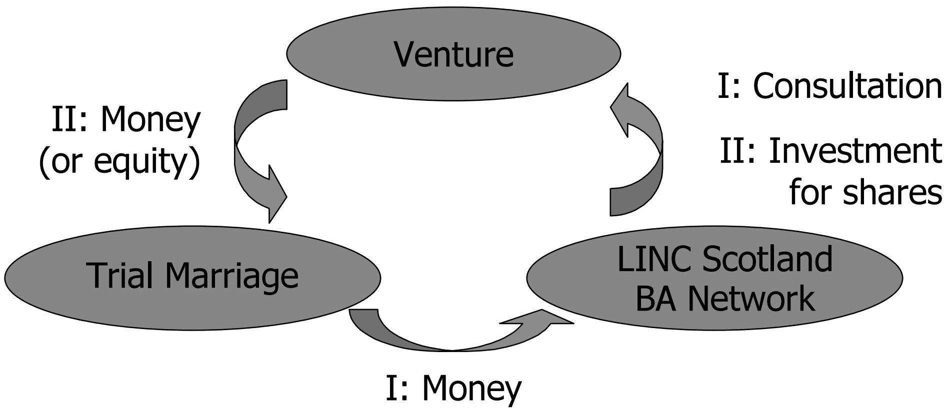


Figure 40. Business Concept of the Trial Marriage of LINC Scotland

In this business model we have three parties and two phases. First, when a suitable candidate is found and accepted on the program, a business angel starts working with the company, using up to 15 days of time to scrutinize and evaluate the venture, and consulting the entrepreneur and resolving open issues in due course. For this work, the angel gets compensation, which would be too low for a professional consultant but is enough for the angel, for whom this is of general interest rather than a source of daily income. The second phase is conditional: If a positive investment decision is made, the grant is returned to the program. The model is fairly cost-effective, especially when we note that five out of six target companies were eventually invested in. Thus, most of the money was returned back to the program.

While LINC Scotland as a business angel network and the business angels operating within it can be seen as traditional V2C actors, the Trial Marriage program itself has several unique qualities. First of all, as it uses business angels as business development consultants, it is fairly scalable as long as business angels are available in quantities. In most countries this is better than relying on consultants, which are a more finite resource. Secondly, even though the initiative is public, it only draws a little amount of public funding, leveraging its effect on private investments. And to conclude with, it is designed to be self-sustaining in the long run, with income from exits from former Trial Marriage companies, in which the fees have been converted into an equity stake owned by the program. (Mason and Harrison 2002a, 2004)

The organization of the Trial Marriage program could be described as a non-professional yet bureaucratic *entity*, due to the involvement of many parties and *public funding* from the European

Union in this *public-private partnership*. When time span is considered, the program itself is short-term activity, but the work has potential for long-term effect as business angels become committed to the target ventures. Also, if the option to convert the grant into shares of target venture is used, the program itself becomes *committed* to the success of the company, but, being a public program, not dependent on it.

### 4.2.2 "Virtual CEO" – a Business Angel minus Money

The Virtual CEO is an unofficial and informal concept presented by Randy Komisar, when he describes his own work in his semi-fictional autobiography "The Monk and the Riddle" (Komisar 2001b). The concept has been interesting enough to inspire a Harvard Business School case (Roberts and Tempest 1998). As there are other individuals working according to the same model[12], it deserves a place in our analysis for a V2C taxonomy. References to the term can also be found in other literature in a more general context (Amis and Stevenson 2001).

Komisar was asked by the Harvard Business School to write a book for them (ABCNews 2000), and in this book he tells a fable of an aspiring young entrepreneur, setting him straight and telling about his current way of doing things as well as his past experiences in practising law or working in high-tech ventures such as Apple, Claris, GO, LucasArts or Crystal Dynamics. After those, he has worked as a Virtual CEO at least in TiVo, WebTV, MondoMedia, IQ.Commerce, Great Entertaining, Magnifi, Digital IQ, Kontiki, Full Audio, Many Futures and FHP Wireless (CC2001 2001, Strathclyde… 2002). He also serves at Stanford Technology Ventures Program (Strathclyde… 2002) and is said to preach Buddhism to businesspeople (The Connection, 2000).

To put it simply, a Virtual CEO is a business angel without money. He possesses such skills and networks that the entrepreneur or founders of a new venture are willing to give him a stake in the company, knowing that he in turn will contribute his time and knowledge for developing the company. As a Virtual CEO, Komisar works with five to six companies at a time, and is "paid largely with equity" (Komisar 2000). The expected time-span of the task is the first two years of the start-up (Smith 2001). Upside potential resulting from equity stake gives incentive to the Virtual CEO, and it is easy to imagine that this is a win-win game.

This kind of "career" is not for everyone, as noted even by Komisar himself. One of the key driving forces for him is the passion he has for the businesses before engaging in further co-operation, and as he says, he wants to gamble with ideas, as many at a time as possible (Komisar 2000). This kind of freedom requires the person to be financially independent, which Komisar has apparently been after his successful exit from Claris. Financial independence or wealth is also a prerequisite for being a business angel. Further similarities between a business angel and a Virtual CEO include that both operating models can be handled either full-time or part-time, and unlike a venture capitalist neither has compelling reasons to make investments. They rather make them of their own free will and the screening process could be described as "selection by compassion", an impression which emerges from the following quotation from Komisar (2001a):

- *"The People: Do I relate to them and their work? Will they be exciting to work with?*
- *The Product or Service: Is it something I care about, something I am personally interested in?*

---

[12] Including the author.

- *The finally the Impact: Is it a big idea? Will it be a viable business? Can I actually help build something that will survive in the big market and thereby realize the potential of the big idea?"*

The justifications a business angel makes before committing to an investment are in many aspects fairly similar, concentrating perhaps more on the personal chemistry between the investor and entrepreneur and thinking less about the impact of the product. On the other hand, the Virtual CEO has to be able to potentially offer more expertise and intellect to the entrepreneur than a business angel, as the only justification for giving away shares is the expertise he is bringing with him, not money.

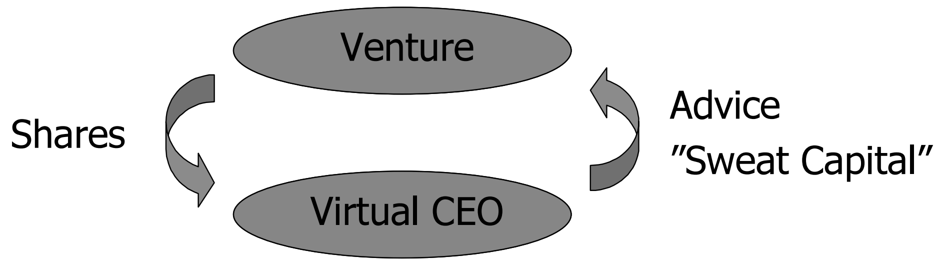


Figure 41. Business Concept of a Virtual CEO

The business model looks very much like that of a business angel, except that money has been removed from the equation. Unlike a business angel, the Virtual CEO *does not invest money*, but still they both become *committed* to the company through a vested interest in the form of shareholding. We also get this model by replacing "money" with "shares" in the advisor model. Additionally, the model is exactly the same as the Source Code Finland model also presented in this study, just that in this case we are dealing with a *private individual*, not a legal entity.

### 4.2.3 "Source Code Finland" – Sweat Capital Investor

Source Code Finland and eAccelerator (see Chapter 4.2.4) resemble each other in many ways: They both have a professional organization and a fairly fixed time span, making work-intensive investments in existing companies. On the other hand, Source Code Finland explicitly prefers equity to monetary payment as compensation for the services. Also, it only invests its own time, "sweat capital" as quoted by their executive in an interview, and does not provide any capital for paying for the services of other advisors. (interview Annala)

The operation of Source Code was officially launched on 10th January 2002. The founders of the operation are Sitra (see also Chapters 4.2.8, 4.2.9 and 4.2.10 describing the services in the PreSeed operating model of Sitra), Mentorium Venture Connection and Stratos Ventures, all of which make early stage capital investments (Source Code Finland 2002). The general idea is to work together with incubators and technology parks by offering start-up IT companies assistance in commercialization, sales, marketing and other business skills required at the same time raising capital, initially mainly from the founders (Sitra 2001a, Ranta-Aho 2002).

The founders invested the capital required to operate Source Code for several years, i.e. until the operation was planned to be profitable through sales of services and – in the long run - successful exits from target companies (Sitra 2001a). According to Petri Vahvelainen, who originally created the concept for Sitra, the company should reach profitability in three years with fixed annual fees paid by the target companies and by success fees in the form of exits (Apunen 2002).

By November 2002 they had screened 105 companies but not made an “investment” yet, though their estimate was to close ten deals per year (Annala 2002). Six months later their web pages presented two target companies, Softageneraattori Oy and Wimeapp Oy (Source Code Finland 2003). In fall 2003 they refocused the operation by launching the Software Business Academy program, where 21 software companies were being coached for success. In spring 2004 three of these companies received venture capital investment, but Source Code Finland was no longer interested in obtaining equity ownership in the target companies. This was explained to reflect the withdrawal of their main funder, Sitra, from venture capital investing. Hence, Source Code Finland is shifting towards consulting and training, and the success of the original model remains to be seen.

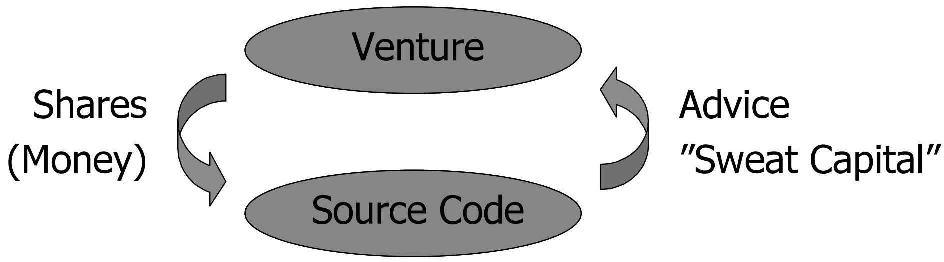


Figure 42. Business Concept of Source Code Finland

The original business model of Source Code Finland is fairly similar to that of a business angel, but unlike the case of an angel there is no capital investment in the company. Instead, one of the defined functions of this V2C player is to guide the target venture to venture capital round one, and presumably exit at round two or later, adding value to the company at each phase. The time span is planned to be in the range of two years from entry to exit. Since the operation is not limited to any particular activity but aims to cover the whole operation of the target company, this can be deemed a long-term interest even though the actual time span is more medium-term. It is also committed financially through the vested interest in the form of shares, which only bring profit to the V2C player if the venture is successful.

When looking at the Source Code Finland business model more closely, we note that it in fact resembles one specific category in the typology of angel investors created by Benjamin and Margulis (2000), called *Barter Investor*. In exchange for equity, these inherently participative investors provide the services which the company would have used capital to pay for. They do offer both capital investment and infrastructure, making them akin to incubators, but are individuals and rely on their own judgment in deciding to invest.

Time will tell if the operation will indeed turn out profitable, gaining enough revenue to cover the operational costs by sales of services and eventual exits from portfolio companies. Until then, it is dependent on outside financing, part of which is public money from a state-owned VC company. These costs are substantial if the actor wants to provide its target companies with the support it promises. After all, early-stage VC companies have found it difficult to operate in this arena since the operating costs are so high compared to the management fees they get from the small early stage funds. Compared to them, Source Code has even less income, but on the other hand can keep all the money from the exits. Hence, they may have more upside potential in the end if they survive long enough.

All in all, as an *entity* Source Code Finland is a *public-private partnership*, which *does not invest money* but still becomes *committed* to the success of the target venture through shareholding. The shares are obtained by working for the company as an advisor, for which compensation is received in the form of equity.

### 4.2.4 "eAccelerator" – Business Accelerator

eAccelerator is one of the six programs of eTampere, which is an umbrella project promoting e-business, e-society and new economy in many forms in Tampere region in Finland. The heart of the region is the second biggest city in Finland, where manufacturing industries have traditionally been dominant. The transformation to a new economic basis has been quite successful, however, compensating to large extent for the loss of jobs in heavy industries, textile mills and shoe factories.

The city has been actively involved in many actions and organizations supporting this positive development. One the most recent initiatives is eAccelerator. It is operated by a leading business development agency in Tampere region, Hermia Business Development, which has been working closely together with the Hermia Science Park and the adjacent Tampere University of Technology. The target of the actor during the five-year project period, i.e. by end of 2005, is to assist up to 25 companies onto international markets, with €50 million of venture funding received by these companies (Ranta-Aho 2002). The objective also includes that the target companies grow to have a total personnel of 1500 people and a turnover of €250 million (eTampere 2002), for which the given time frame - if applicable - is fairly tight.

Nevertheless, growth potential is of the essence for the companies applying for the eAccelerator program. The very idea of the program is to assist the companies in their early stages in a manner which allows them to start fast growth earlier than without assistance, noting that sometimes fast growth is the only alternative. It has to be remembered that in Finland - as also more generally in Europe - the venture capitalists do not make investments in as early stages as in the US, where in many cases they are the medium accelerating the growth. Furthermore, the angel investor market in Finland is fairly thin, thus a public or subsidized operation to assist start-up companies can be justified. The attached Figure illustrates the effect of speed as seen by the program (eAccelerator 2003).

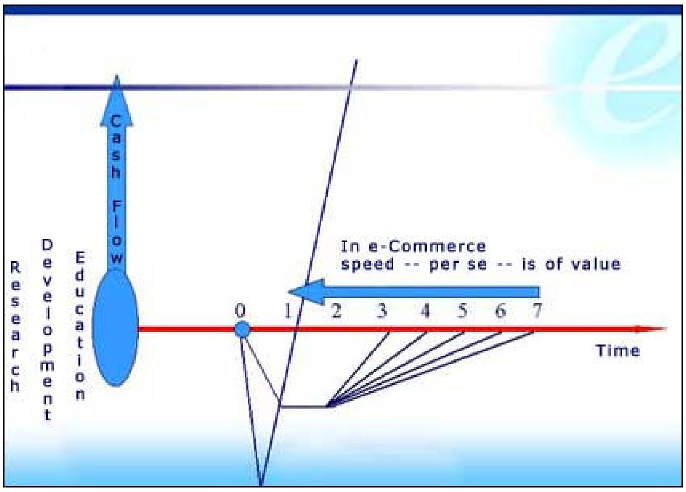


Figure 43. Efficiency and Speed as Seen by the eAccelerator

Companies are screened in a normal manner with public funding, but also by use of a business plan competition, trying to promote entrepreneurship. Once accepted, the entrepreneur has to commit to stay in the project for up to 36 months, which is also the explicitly mentioned maximum time before exit. At this stage, the contract still depends on its approval by the Advisor Board, consisting of more than 50 names of local experts divided in three categories; Finance, Growth and Technology. Contracts with accepted companies are tailored from case to case, with variable time span, deliverables and compensation method.

In addition to various business development services by Hermia Business Development, ranging from patent consulting and market research to improving the business plan and raising capital, the deliverables may include small amount of investment. The investment is not intended to cover operative costs such as marketing or product development, and is too small for these activities anyway. Instead, it is to be used to cover direct costs of the business development project such as use of other experts or patenting, according to the guidelines agreed in the contract in beforehand.

Furthermore, the large number of people in the advisory board can be used for networking. One of the declared benefits of eAccelerator is its capability make contacts and facilitate strategic alliances. For these purposes eKiihdyttämö has also partnered with several supporting organizations from legal, recruitment, telecommunications, venture capital and consulting sectors. (eTampere 2002) Naturally, marketing material also brings up the connection to the city of Tampere who participates in funding the program and the licencing office of Stanford University, which has a minor equity stake in Hermia Business Development (eAccelerator 2003).

The method of compensation is preferably straight money, but a success fee or equity may be used as well. Payback is not immediate, but triggered by set milestones, such as VC funding or major sales deals. Payback may also be conditional, which brings more risk and incentive to the scheme. Compensation by equity stake brings in risk and incentive as well, but this can be seen in a positive light, since raising capital for the portfolio companies and preparing them to be attractive to the investors in one of the key ingredients of the program. In November 2002 more than ten companies had been accepted for the fairly active program, and the results were promising.

As of June 2004, Heidi Huhtamella of eAccelerator stated, that most of the goals would be achieved. The personnel target of 1,500 employed by the target companies may prove to be too high, and the metric for venture capital funding received is broadened to include all outside funding. Regarding the number of companies and turnover the goals will presumably be achieved. An interesting notion is that as she says the whole host organization, Hermia Business Development, has in a way transformed into an accelerator to both achieve the goals and to respond to the changed business environment. Alas, the environment has definitely changed since 2000 when the project was planned and the goals set.

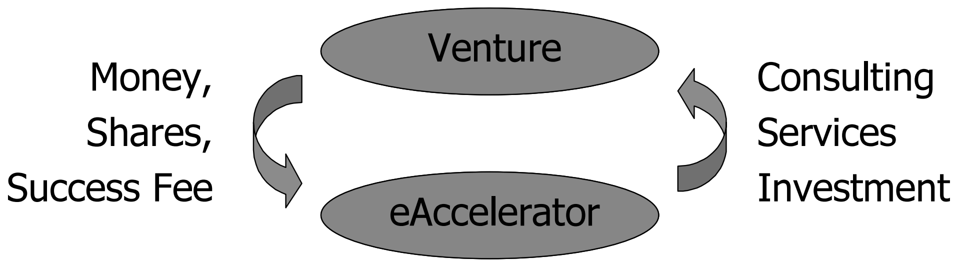


Figure 44. Business Concept of the eAccelerator

The business concept of the eAccelerator is a mixture of business angel, advisor and seed VC, which is natural since its operation has features from all of these players as well. A business angel would give more money and only accept shares in return. Investment from a seed VC would be much less consulting-intensive and concentrate on the capital injection instead, while an advisor might give the same amount of consulting but not accept conditional or equity payback. Finally, what was said about the Barter Investor in connection with Source Code Finland earlier also applies well to eAccelerator.

Depending on the assignment, the time span may range from short to long. It tends to be at the longer end and definitely is if there is a vested interest in the form of equity, a success fee being usually a medium range incentive. Because of the methods of compensation it can be considered *committed* to the success of the target venture. As an *entity*, the eAccelerator is a *public-private partnership,* as it is funded mostly by public money and run by a private company. The main part of investment eAccelerator makes into a company is *not the money* but the work they do for the company as consultants. Still, the money it invests is its *own money* from the balance sheet.

### 4.2.5 "UK Venture Capital Trust" – Channeling Funds to Small Companies

Numerous programs available to small companies and their investors in the United Kingdom show that local government has been very active and innovative in creating legislation supporting financing of small and medium sized enterprises. The Loan Guarantee Scheme, Business Expansion Scheme, Enterprise Allowance Scheme and Enterprise Investment Scheme and others are designed to help those companies either directly or indirectly e.g. by giving incentives and tax deductions to investors (see e.g. Cressy and Cowling 1994b, Lonsdale 1995).

There is also a type of financial entity created for the same reasons, Venture Capital Trust or VCT. In a nutshell, Venture Capital Trusts are companies listed on the London Stock Exchange, which specialize in investing in small and risky unquoted trading companies. The target companies are basically the same which qualify for another program mentioned above, the Enterprise Investment Scheme. When investing in a VCT, the investor is able to spread the risk over a number of these small companies. (Bushrod 2002a) As a British financial advisor, Bestinvest notes in its VCT Frequently Asked Questions list, it is difficult to see VCT as a high risk investment, provided its venture capital portfolio is adequately diversified to at least 20 holdings (Bestinvest 2003).

VCTs are mainly managed by venture capital management companies. Established by the Finance Act 1995 they invest principally in new shares and securities, including loan stocks, of unquoted companies. In three years, 26 VCT's had raised £535 million and established themselves as both an attractive form of investment for private investors as well as a good source of venture capital for unquoted companies. (Cartwright 1998) Since 70 percent of this equity by definition has to be invested in unlisted companies within three years of raising, the impact on small business finance is evident. (Cartwright 1995, Dobree 1995)

Several tax incentives have been built into the VCT scheme for income as well as capital gains tax. First of all, investors receive initial income tax relief of 20% for up to £100,000 invested in a VCT per year. Effectively, the result is that every pound invested only costs 80 pence for the investor. Secondly, investors who subscribe or acquire ordinary shares in a VCT are not liable for UK income tax for dividends in respect of investments up to the same annual amount, £100,000. Regarding capital gains tax, the investors may defer a chargeable capital gain by investing the amount in a VCT as long as the investment is held for a minimum of three years. Furthermore, if investors dispose of ordinary shares in a VCT this will not give rise to a chargeable gain on those shares. (Cartwright 1995, Advent 2003)

On the other hand, there are rules and restrictions applied to the VCT. To maintain the tax benefits it has to invest in three years and hold at least 70% of its funds in qualifying investments. The target companies have to fulfil the conditions of VCT and EIS investment, being either unquoted or traded on the OFEX "off-exchange" or AIM, Alternative Investment Market of the London Stock Exchange. VCT must not control any company in which it invests or invest in a company which is controlled by another company - regulations which are standard practices in most VC companies as well. Target companies may not be worth more than £15 million before or after the investment, and maximum allowed investment per company is £1 million per year, not exceeding 15% of the total funds in the trust. Furthermore, the companies have to be wholly or at least mainly in UK. Loans and loan terms are controlled, and certain instances may cause the tax reliefs to be lost. (Cartwright 1995, Greene and Maddalena 1995)

At the present moment, the liquidity of the shares of the almost fifty VCTs is low, despite the fact that they are quoted in the London Stock Exchange as dictated by the Finance Act 1995. A major reason for this is that whenever an individual sells the stock he will lose the ongoing tax benefits, effectively issuing a tax penalty on sales. (Quester 2003, Bestinvest 2003) This lack of liquidity means that VCT cannot be regarded as an investment instrument for everyone.

Nevertheless, the VCT scheme seems to work. The average investment of a VCT between 1995-98 was £508,000, which seems to address the equity gap issue fairly well. Furthermore, even though some concentration in the Greater London Area and South East England is imminent, the investments are in general fairly widely spread geographically and directed to various trades and stages of company development. (Cartwright 1998)

What is especially encouraging to see is that the British government is improving the legislation from time to time, allowing the VCT scheme to better solve the problems it is supposed to address. For instance, the rules precluding the VCTs from being able to control the companies in which they invested were relaxed already in 1995, when the first VCTs had merely started to capitalize themselves. At the same time a number of Statements of Practice were issued by the Inland Revenue, setting out their approach to various situations. (Greene and Maddalena 1995) As for a more recent example, the March 2000 Budget announced new legislation to be created to allow certain investments to retain their eligibility for tax relief and by year 2002 it was possible for two VCT's to merge without losing their tax reliefs (Bushrod 2002b). This speaks for the fact that the Venture Capital Trust has been found a useful financing instrument worth developing.

In order to further illustrate the Venture Capital Trust we use a practical example by looking at the VCT activity of one of the leading independent venture capital companies in the UK, namely Quester. Founded in 1984 and managing approximately £300 million at the moment, they have also become a leading VCT house in the UK. According to the director and co-founder of Quester, John Spooner, their entry into the VCT business involved a fortuitous act of timing, as when the Finance Act of 1995 came into force they had an embryo of an angel investing business that planned to have some passive and some active members. With the arrival of VCT legislation these wealthy individuals were placed in the first Quester VCT, which raised £32 million in 1995/96. (Bushrod 2002a, Quester 2003)

Since then, Quester has assembled four more VCT's at one or two year intervals, the first three of which raised £45, £48, £53 million respectively, while the Quester VCT five was closed with £22 million in April 2003. Still, taking into account the difficult investment situation of the time, the sum can be regarded as satisfactory for a new trust and further consolidates Quester's position at the VCT market. The three first trusts have been completely invested in compliance of the legislation which required the funds to be invested to eligible investments within three years of closure. (ibid.) It remains to be seen if Quester will use the opportunity of new legislation allowing the merger of VCT without tax penalties; reducing the number of VCT's from five to one might result in lower management overheads, reduced audit costs and improved liquidity on the market.

For a VCT it is critical to get good deal flow of early stage investment proposals, for which Spooner lists several sources. First of all, the VCT investors themselves are a good source of deal flow, as many of them work in banks and broking houses and when seeing a potentially good deal refer it to their own money manager. Past investee company management teams also provide deal flow, either directly or by referrals. A third good source is provided by Quester's involvement in the University Challenge Funds (see also Chapter 4.2.6). Quester manages two such funds, firstly the Sulis Seedcom Fund for the universities of Bath and Bristol and secondly the Lachesis Fund for the East Midlands University Consortium. Noting that they also manage the ISIS College Fund VCT for Oxford University, we can conclude that a considerable amount of deal flow originates from these university connections. (Bushrod 2002a)

Some VCTs are established to invest solely in AIM flotations (Cartwright and Orpen 1997). This is not the case with Quester, who had invested £103 million in 53 unquoted or AIM-traded companies since the launch of their first VCT in 1996 until their fourth VCT was closed in April 2003. Thereby their average investment per company is almost two million pounds, which is well above the average of £508,000 the VCTs had invested per company in 1995-98, as noted earlier. One reason for this may be that they have had to make successive investments in their target companies.

All in all, the Venture Capital Trusts play an important role in the UK venture capital market by providing funds to fill the equity gap between £250,000 and £1 million, encouraging an increasing number of private companies to seek finance for expansion which provides an important stimulus for the economy, providing a significant amount of funds for young high-tech companies, enabling smaller MBOs and MBIs and participating in the new issue element of the Alternative Investment Market or AIM, the growth stock market of London Stock Exchange (Cartwright and Orpen 1997).

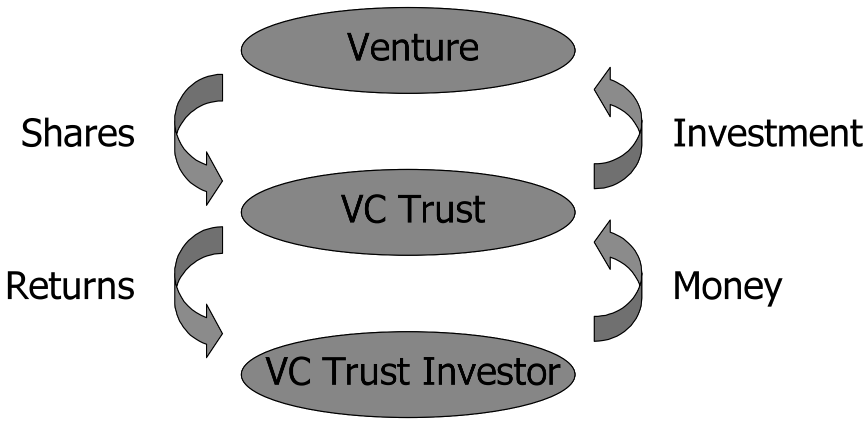


Figure 45. Business Concept of a Venture Capital Trust

The business concept of Venture Capital Trust involves several parties. First of all, there are the *VCT Investors*, who are *private individuals* investing their *own money* in small companies through the Trust. Therefore, they are also *committed* to the success of the companies, although they can also sell their shares in the public market at a quoted price. Second, the *VC Trust* itself, which is principally a *private entity*. It invests *other people's money* on an equity basis and thus becomes intimately *committed* to the success of its target ventures. We could also consider the Manager of the VCT as a V2C actor, but it is basically identical to any other VC Fund Manager and therefore irrelevant to this study.

### 4.2.6 "University Challenge Fund" – Facilitating University Spin-Offs

Another of the British innovative solutions for promoting entrepreneurship and fighting the equity gap besides the Venture Capital Trust described in Chapter 4.2.5 is the University Challenge Fund. According to the Office of Science and Technology (2002), the purpose of the "University Challenge" is to enable universities to establish seed funds, which will assist the successful transformation of good research into good business. This early funding is regarded as the riskiest stage of the venture process. The objectives of University Challenge are to:

- allow winning universities ready access to seed-fund capital to turn the results of research into potential new businesses and/or products
- catalyze the activity in the seed funding of high technology, an area still not well served by the UK Venture Capital industry
- educate UK universities in the investment process and bring the financial community closer to universities
- provide stimulus to entrepreneurial activities in the university sector. (ibid.)

The University Challenge Fund Scheme was announced by the Chancellor of the Exchequer in March 1998 as a collaboration between the Government and two foundations, the Wellcome Trust and the Gatsby Charitable Foundation, who contributed £25 million, £18 million and £2 million, respectively. The total funding available was therefore £45m. In June 1998 a competition was launched and all universities were invited to apply. Finally, 15 seed funds of between £1M and £5M in size and representing total a of 37 institutions were established all over the UK - in many cases, the fund was a joint effort of several universities and research institutions. With the required 25% matching fund required from the participants the total amount of investment capital in these funds was in excess of £60 million. (ibid.)

The University Challenge Fund of the University of Oxford provides us with a case example of this kind of V2C actor. It received an award of three million in the first UCSF competition for its own seed fund, adding another million to complete this fund of £4 million. The fund is managed by Isis Innovation, a wholly owned subsidiary of Oxford University. (Isis Innovation 2002) Isis was established in 1988 as the technology transfer company of the university. In addition to assisting researchers in IPR issues and such it also hosts an array of other services, such as the seed fund in question and a business angel network called Isis Angels Network. (Isis Innovation 2003) However, they should not be confused with ISIS Asset Management, having its main offices in London and Edinburgh and managing two VCTs, among others (Isis Asset Management 2004).

According to the guidelines publication made for applicants by Isis Innovation (2002), their typical development project investment is from £10 to £100 thousand, while spin-out investment are said to be between £100-250 thousand. Funds are not to be directed to bricks-and-mortar projects, such as establishing incubators. Investment types are divided in five categories:

Table 12: Possible project activities funded by a University Challenge Seed Fund

| | |
|---|---|
| Type 1: | Initial proof of concept |
| Type 2: | Pre-patent research |
| Type 3: | Reduction to practice |
| Type 4: | Commercial demonstration |
| Type 4: | Spin-out company |

Tom Hockaday, Executive Director, further simplified this by stating that they make three different kinds of investments. First, they may invest in an internal project when it is still made inside one of the laboratories of the university. Secondly, they invest in projects preparing a business. And finally, they provide first-round cash for spin-out companies. (interview Hockaday)

The first step in applying for funding from the Oxford University Challenge Seed Fund is to complete the Project Summary Form readily available in the guidelines booklet. This can be done together with an Isis project manager, but it is also available on the Internet just as is the whole guideline booklet, showing admirable openness from this actor. This is followed by discussions between the Isis team consisting of the the managing director and the project manager and the researcher team. In the case of a positive result, an Investment Proposal Form is prepared for the Investment Advisory Board, which is a fairly small group consisting of five people closely connected to the university. (Isis Innovation 2002)

If the Investment Advisory Board approves the proposal, an Offer Letter is sent to the applicant. This letter, a template of which is again available in the booklet, includes a number of standard obligations for the company and stipulates certain rights of the university regarding the investment. The most notable of the latter are the provision for the university to convert a grant made to a project to equity, if a spin-off company results. The conversion would be made with same price as the first round investors. USCF also reserves the right to subscribe more shares in the hypothetical company at that point up to their maximum limit of investment, £250,000 per venture. Principles of payback are also outlined for the case of the work financed by the grant generating license income. In the case of a spin-out company, the investment is equity-based to start with. (ibid.)

At a later stage, the Isis Innovation Project Manager will monitor the progress of the project and its achievement of the milestones set prior to investment. The progress reports are examined quarterly by the Investment Advisory Board, which in turn has to make regular progress reports to the UCSF steering committee, i.e. the Office of Science and Technology. Despite these administrative necessities, effort is made to keep the organization as lean and fluent as possible, and researchers/entrepreneurs are advised to expect their Project Summary Forms to be processed within four to eight weeks of receipt. (Isis Innovation 2002, 2003)

According to Hockaday, as of April 2003 the University Challenge Seed Fund managed by Isis Innovation was totally invested in 67 projects between £2,500 and £250,000 each. Out of these, 20 were spin-offs where equity compensation was involved. According to the rules some more investments may be turned into equity stakes at the moment of VC entry. As noted in the guidelines booklet (Isis Innovation 2002), in order for the USCF to become a self-sustaining fund, its investments must offer the prospect of a financial return. Thus, the investments are expected to produce a return, and successful exits from portfolio companies serve this end well.

By leveraging their funding to assist target companies get other investments as well, the challenge funds can help their spin-off companies to actually receive much more funding than available from the challenge funds alone. For instance, in spring 2003 the University of Cambridge Challenge Fund listed on their website (http://www.challengefund.cam.ac.uk/) fourteen projects in which they had invested total of slightly over £2 million, ranging from £10,000 to upper limit of £260,000 per case – which in fact is £10,000 more than the maximum amount of investment allowed per venture. On top of this, £9,8 million had been received from other investors, spanning from a £25k private investment to a £3,4million VC placement by 3i. This leverage factor of 1:5 can be regarded as very efficient.

The results have apparently been satisfactory to all parties; the Challenge Fund has been listed as one of the key public means to extend opportunities for innovation as there will be another round of University Challenge Fund Competition “to provide seed venture funding for knowledge transfer” (Department of Trade and Industry 2000). The Government’s contribution has even been raised from its initial £10 million to £15 million due to the large number of high quality applications (Office of Science and Technology 2002).

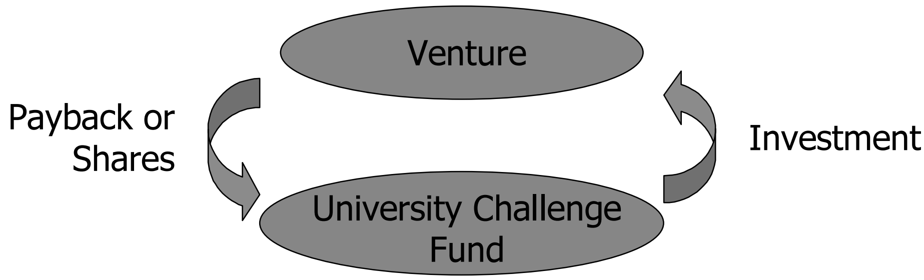


Figure 46. Business Concept of a University Challenge Fund

The University Challenge Fund invests both *public money and private money from other investors.* It gets no other income from its target ventures than success fees and equity compensation and is therefore *committed* to the success of the ventures. Still, being a *private-public partnership* it also serves the strategic and social interests of society and is therefore not entirely dependent on their success.

### 4.2.7 “Venture Stables”- a University Pre-Incubator

As corporations foster the ideas born within their organizations through corporate venturing, some universities have established means to promote the inventions proposed by their students or staff members. There is ample potential in these activities, sometimes referred to as University Incubators or Pre-Incubators (see also Chapter 3.4.1). After all, many discoveries are made in universities but the lack of entrepreneurial spirit may hinder their exploitation in practice. Supporting ideas and entrepreneurship also contributes to the job satisfaction of the staff, although it is noted that attitudes towards academic entrepreneurship vary between faculty members (Laukkanen 2003).

One example of “University Venturing” can be found in Tampere University of Technology, which has a program called *Yritystallit* or “Venture Stables” (www.yritystallit.tut.fi/yritystallit/). When undergraduate or doctoral students of the university have a business idea or an innovation, they can apply for the program. If accepted, the university will cover up to €7,000 of the expenses like premises, computers and phones, which are usually provided by the university. The money can also be used for buying expert services, such as market research or patenting costs. The companies in the program can also takes advantage of the innovation and patenting service present at the university.

Venture Stables calls itself a pre-incubator and is in a sense a “virtual organization”, as the premises are not all in the same place but usually assigned to the faculty where the idea originates in order to help the daily work of the embryonic entrepreneurs. Furthermore, there is no full-time staff, as managing the screening process and supporting the ventures is outsourced to a business development company working closely with the university.

As the screening is outsourced, the organization is practically non-existent. The contract is made for one year, with a rare option for second year, thus the time span is mid-range. The contract includes the option of payback, if the project should become profitable later on, but the rules are quite lax. At any rate, due to local legislation the university cannot take equity ownership of the possibly resulting target company. For these reasons, the activity could be described as “strategic charity work”, with the positive image, the internal job satisfaction, the welfare of society and goodwill in general as ultimate goals.

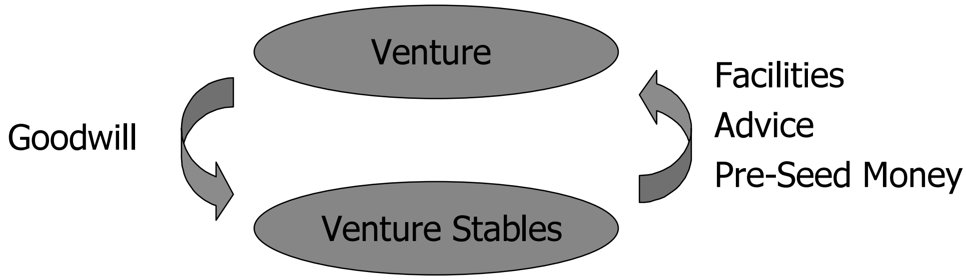


Figure 47. Business Concept of Venture Stables of Tampere University of Technology

The business concept has something in common with incubator, advisor and seed VC, yet the profit model seems to come from charity or non-profit organizations: the venture stables effectively expect no money back from the venture nor nor can they take an equity stake in it. The primary short-term goal for the university is the positive image created by the activity, and in the long term the resulting businesses are anticipated to create research projects and new job opportunities which will also benefit the university.

As a V2C actor, Venture Stables is a *public entity* investing *public money* in the selected ventures. It is *committed* to the success of the company in the sense that its income is dependent on them, although the resulting income is not expected to make the program profitable or self-sufficient.

### 4.2.8 "Liksa" – Pre-Seed Development Funding

Sitra, the Finnish National Fund for Research and Development (www.sitra.fi) was set up in conjunction with the Bank of Finland in 1967 in honour of the 50th anniversary of Finnish Independence – hence the name "Sitra" which is an abbreviation from Suomen Itsenäisyyden Juhlarahasto or *Fund of Finnish Independence*. Since 1991, the fund has operated as an independent public foundation under the supervision of the Finnish Parliament.

The role of Sitra in early-stage venture investments and pre-seed market development in Finland is notable. According to Tuula Laitinen of Sitra, they started a matching service in 1996 but found out a few years later that the service was not working optimally and could use improvements. Hence, a concept of "PreSeed Services" was created, today consisting of three distinct services: Liksa, Intro and Diili. The next three chapters will describe these services one at a time. Sitra is also affiliated with Source Code Finland presented as a case in Chapter 4.2.3 of this study.

The PreSeed operating model was launched on 3rd May 2001 and developed together with another strong Finnish public-sector body, the National Technology Agency known as TEKES. Services were targeted at newly started companies and individuals contemplating starting one, and the aim was to speed up the commercialization of technology-based projects and to help them get into the financing pipeline. (Sitra 2001b) The PreSeed entirety with its three distinct services is shown in the following illustrative figure.

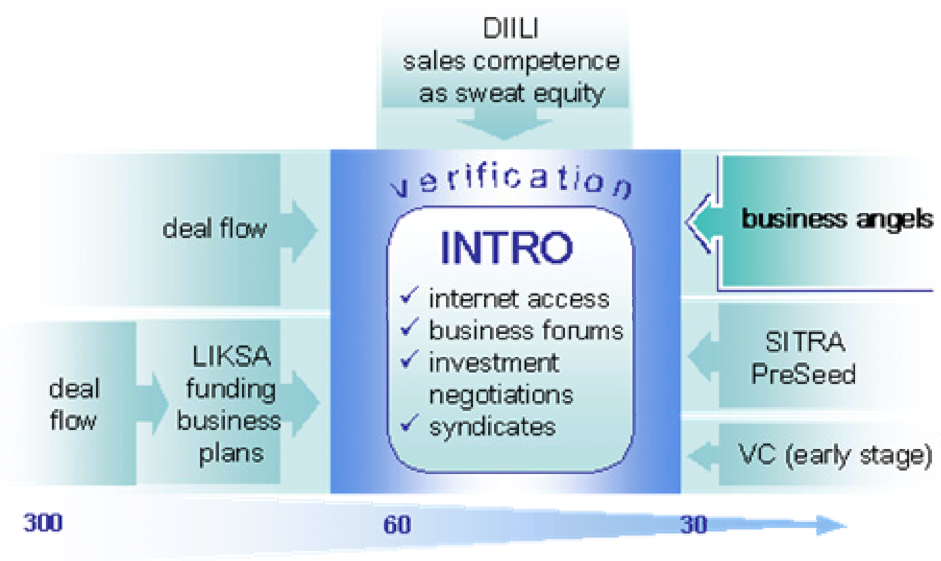


Figure 48. Sitra PreSeed Operating Model

Of the three services, Liksa (www.sitra.fi/liksa) was activated first - in spring 2000 - and it is also the first on the timeline when the development of a company is considered. The name is an abbreviation from the Finnish words meaning Funding for Developing a Business Idea, and – obviously not quite by accident – is coincidentally a slang word for *salary* as well. The objective of Liksa funding is to accelerate the enterprise's eligibility for capital financing in the start-up phase. In other words, the target is to get investment either from informal investors of venture capital markets, which is aided by Intro matching service, the second service in the PreSeed entirety. This is also where the third, more recently started service comes in; Diili, finding sales and marketing executives to match and work in these new technology-based companies on a sweat equity basis. Since the use of the services is not tied together, we divide them into three and present Intro and Diili individual cases in the next chapters, while this chapter now concentrates on Liksa.

Companies and individuals interested in taking advantage of the Liksa program are advised to contact one of the "local operators". These operators are more known as organizations for the commercialization of technology innovations and working closely with their local universities, which may be their partial owners or funders. Nevertheless, the representatives of the operator will make a tentative evaluation of whether the idea is eligible for the Liksa program or not, and aid in setting up the application and project plan for a Liksa project for the applicant.

The local operator also decides at what point the project will be ready to be presented at the funding meeting, if at all. The final decision is made at this meeting, where the entrepreneur will be presenting his case. The main criteria are said to be attractiveness of the market, competition advantages of the business idea, skills of the team and commitment of the applicant – quite in line with the venture capital investment criteria for that matter. Also, the quality of the Liksa project plan and the perceived impact of Liksa funding are of the essence, and finally the business pursued should be eligible for further funding by both Sitra and Tekes. (Sitra 2004)

If accepted, the applicant will get maximum €35,000 of funding for a project taking 2 to 4 months, accompanied by a maximum of €5,000 for a process consultant who will co-ordinate the process. The funding is used according to the plan mainly to buy services from experts in market research, business development and such. Typical outcomes of the project include a professionally honed business plan with up-to-date market information and evaluations of the technology applied and the competition. Costs of research and development or protecting intellectual rights cannot be included, and salaries to the team itself can only be paid in minor amounts and as an exception, for instance if some leave from a permanent job is required.

After the project has been successfully completed it should be ready for seed round private equity investment. One way to work towards this is to transfer the company to the Intro investment matching service, which will be described in detail in the next chapter. Liksa and Intro are separate services, however, and the company is free to look for investment from other markets at any point as soon as the project is over. Nevertheless, Sitra reserves to right to negotiate for an equity investment resulting in a minimum of 10% ownership of the company under the same conditions as the new investor. If case Sitra makes an offer for this investment but the company rejects this offer, half of the Liksa funding – the share of Sitra - is to be returned. This also applies if a VC funding offer is accepted during the Liksa project itself.

By April 2003, when 350 proposals had been screened and of these 90 had received a positive funding decision, software companies accounted for 40% of the successful candidates, while electronics and combined medical research and biotech were at 17 per cent each (Hallikainen 2003). In December 2003 the one hundreth positive decision was made after 420 applications had been processed. As told by Laitinen, at that time 80 Liksa projects had been completed and 83 companies gone through the Intro service, half of which came from Liksa. This means that about half of Liksa companies stick with Sitra PreSeed services and follow on to Intro.

Liksa has been criticized for a number of its characteristics. First of all, compared to the actual added value accruing the target companies in the form of investment and advice, the organization is seen as fairly heavy, resulting in ineffective use of resources. The logical counterargument is that Liksa works as planned: it was an innovative concept when it was conceived, and any party having a better idea is free to realize it. Still, having a leaner organization could allow the application process to be easier and acceptance rate higher.

Entrepreneurs have also wondered about the practice and limitations of paying salaries to the applicant or team during the initial build-up of the company with Liksa funding. At the beginning of the program the entrepreneur was entitled to a maximum of 25% of the total funding as wages. This did not encourage penny-pinching or haggling over the prices with outside consultants; if money was saved, the excess funding was not given to the entrepreneurs as wages but conversely; as the total amount of funding used diminished, so did the quarter reserved for the entrepreneur, many of whom needed the money to compensate the lost or diminished income from their main jobs. The current terms of the Liksa program state that the funds can be used for the entrepreneur's own salaries only in exceptional circumstances, for instance in case a leave of absence is needed from the permanent job, but so far this possibility has not been implemented.

A third, less obvious issue is that in a smallish economy such as Finland this easily becomes the *de facto standard*. Since it is a highly visible service and well known by the actors whom the embryonic entrepreneurs contact first, it is very often suggested for them. If the entrepreneur fails to be accepted, it may affect his chances of raising funding elsewhere. The reasoning applied is: "if the idea did not get Liksa funding, why would anyone other be interested in it?"

Furthermore, when venture capitalists are presented with a company which is not quite eligible for VC funding as yet, they advise the entrepreneur to try to get Liksa funding first and if not successful then to come back. This makes sense, of course, but the practice is also used as an unofficial excuse for getting rid of candidates which look unpromising at first sight and only throws the venture in another direction.

Still, the Liksa program has many good qualities. First of all, as the name of the complete program suggests, it targets the pre-seed market, where there are a lot of ideas but little capital. Secondly, it brings inexpensive funding to the reach of prospective entrepreneurs, without forcing them to compromise their future by mortgaging the house or quitting their jobs at once. Finally, it includes a path towards the next stage, private equity investment, in the form of the Intro matching service.

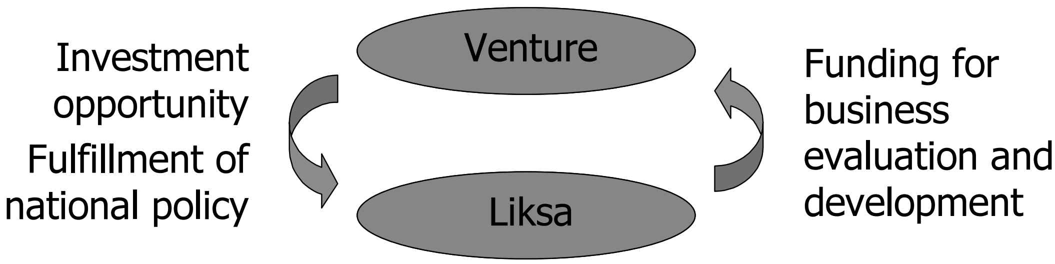


Figure 49. Business Concept of Liksa

When looking at the business concept of Liksa it is obvious that it is not so much a business model as a mechanism for channelling *public money* to companies in the pre-seed stage. The organizing operative, Sitra, is a public fund supervised by the Parliament of Finland, and the share of the PreSeed activities totalled to mere half per cent of all of its funding decision. Liksa has a vague pay-back model built into it, realized by the option of co-investing with the seed round financiers. This makes it in a sense *committed* to the ventures it works with, but the operating costs can hardly be expected to be paid back through returns from these indicative investment opportunities. Hence, a more important return to this *public entity* is the fulfilment of a national policy, which it is realizing.

### 4.2.9 "Intro" – Matching Service both Live and On-Line

Intro (www.sitra.fi/intro) is a matching service - or a marketplace as they say they would rather call it - operated by Sitra as a part of their PreSeed services entirety consisting of three distinct services, which was described in more detail at the beginning of Chapter 4.2.8 (see also Chapter 4.2.10). It was launched in early 2002, about a year later than the Liksa service described in the previous chapter (Sitra 2003a), and can be seen as a continuation for the matching service started in 1996 by Sitra and Finnish Venture Capital Association FVCA (Leinonen 1999).

As can be seen from Figure 48 on page 145, the operating of Intro is multi-dimensional. It is a service working for entrepreneurs looking for investment, for investors looking for investment targets and for sales professionals, who can join the entrepreneurial team at this early point on a sweat equity basis, resulting in presumably interesting possibilities with high upside potential. This last dimension, to match sales professionals with fledgling companies, is in fact a separate service called Diili or *the deal*, which will be introduced in more detail in the next chapter.

The deal flow of Intro comes from entrepreneurs, business development organizations and from the Liksa business development service. Conceptually, these three sources differ enough to complement each other: "cold calls" by entrepreneurs come directly from outside, while Liksa companies are already inside the PreSeed treadmill. Various business development organizations are naturally inclined to introduce their clients to the service, for which reason they are invited.

Entrepreneurs wishing to join the program can use the website to order the application form, which is to be completed and returned along with a business plan and financial information for approval. The selected companies have to be willing to take the investment, commercially promising companies in the start-up phase or turning point, possessing qualities which are anticipated to interest investors. If accepted, the companies will be introduced to formal and informal venture capital investors in the Intro network. On the application form, the applicant can express preferences about the amount and source of investment; whether it should come from business angels or private venture capital companies, whether syndication is acceptable or even preferred, and what kind of expertise and role is expected of potential investors.

As explained by Tuula Laitinen of Sitra, once a company has been accepted for the Intro program, it will be exposed to the pool of investors by an Internet portal initially for a three month "Introduction Period". Besides this rather passive and faceless element, Sitra organizes group meetings and forums as a part of the PreSeed program – an activity seen as a crucial part of the PreSeed services by Sitra, both in the sense of Intro and Diili. If the company sparks interest among the investors during the three month period, the period can be extended until the negotiations have been completed.

For investors, the service offers a centralized channel of pre-screened investment proposals, supposedly resulting in a refined deal flow. Another imminent benefit is the opportunity to syndicate investments through the Intro network. All of these can be seen as helpful to all investors and especially for inexperienced business angels, lowering their entry barriers and thus potentially bringing new business angels to the meager informal venture capital market.

One of the deficiencies Sitra saw in their PreSeed package was the lack of business skills and sales power in the founding team. As this was considered to be the single most important obstacle slowing down the investment process, Sitra initiated a third service for matching sales and marketing professionals to Intro companies. The Diili service addressing this problem will be introduced more closely in the next chapter. (Sitra 2003b)

According to Sitra, the Intro marketplace accounted for a significant portion of all first round investments during its first year of operation. It is expected to grow to be even more important, especially now when the Diili service has been started, which – if successful – will make the targets even more attractive to investors. During the first year the service gathered more than 150 registered investors, and in two years the number had risen to over 200 people. Typical investment was syndicated between 2-3 investors, occasionally supplemented by venture capital from either Sitra funds or private venture capital companies. (Sitra 2003a, interview Laitinen)

As told by Laitinen, by December 2003 Intro had introduced 74 companies to investors, half of which had previously gone through the Liksa process. Of these, 21 companies had received an investment, representing an over 28% share which can be considered a fair result. Sitra has co-invested in some of these. In addition to monetary support, the investors are said to have provided the target companies with guidance and sparring; after all, "an owner is a more committed partner than a consultant". (Sitra 2003b).

Intro has been able to leverage the use of public funding; whenever the start-up company can show that it has arranged the required proportion of internal financing from private sources, it is often eligible for funding for e.g. research and development from various public sources, multiplying the actual effect of financing. (Sitra 2003a) Laitinen says, that Sitra has been able to operate on both national level as well as organizing the current 200 business angels into "local chapters" in a manner which allows the introduction of companies to local investors. And to conclude, Intro also promotes the exit possibilities for the early-stage investors, addressing the early stage exit problem noted in Chapter 3.2.4.

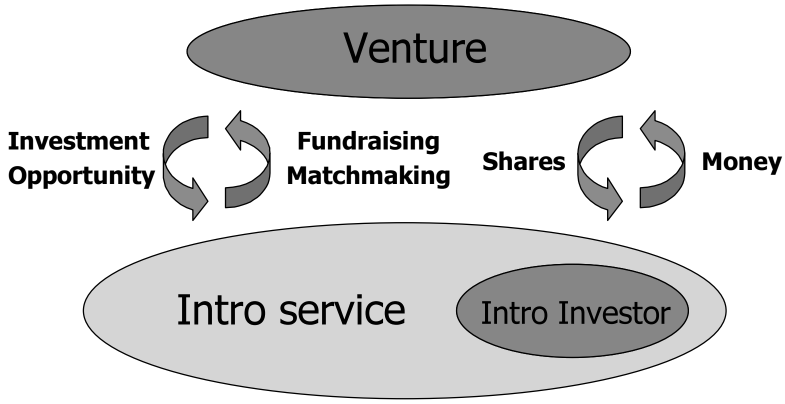


Figure 50. Business Concept of Intro

The business concept of the Intro service is close to that of a business angel network, but in addition to business angels Intro also works with venture capitalists and – through the Diili service – with professional individuals. The last group will be analyzed in the next chapter and venture capital has already been assessed. Therefore, regarding this study the most interesting actors are the Intro service itself and the individual investors working through it.

Of these two, the *Intro service* is a *public entity*, while the *Intro investor* is a *private individual*, becoming *committed* to the target company due to ownership obtained by investing his *own money*. The service itself, on the other hand, does not require money or ownership in the company. Therefore, it has no commitment in the long run, although the parent organization, Sitra, may become committed in the target by a venture capital investment.

### 4.2.10 "Diili" – Experts for Start-Ups

The third component of the Sitra PreSeed services described in this and the two preceding chapters is the Diili matching instrument for companies and sales professionals[13]. Stimulus for initiating the Diili service came from the experience that the single most important factor delaying or impeding investments into the companies in the Intro matching service was the perceived lack of business skills and – more precisely – credible sales and marketing force in the target companies (Sitra 2003b).

Tuula Laitinen of Sitra explains, that Diili addresses this deficiency by including sales and marketing professionals as the third target group in the Intro service besides companies being the potential investees and investors providing the capital. Registered professionals get access to the same companies the investors are looking at in the Intro service, provided that the target company has chosen this option. Similarly, the companies registered in the Intro service can browse the CVs of registered Diili candidates, but mostly without names attached.

According to Risto Kalske of Sitra, the people looked for are entrepreneurial experts in sales and marketing, whose situation in life allows risk-taking and who have drive and international experience to take the innovations out to the marketplace. In these markets experience is the capital

[13] The whole PreSeed model itself was described in more detail at the beginning of Chapter 4.2.8.

and age is no obstacle, quite the reverse. Thus, these people can gravitate to the entrepreneurial teams of these young companies, receiving posts with significant responsibilities and bartering their work and experience for equity stake on a sweat capital basis. (Sitra 2003a)

The companies get to see the brief CV the candidate has provided and a maximum of three areas of expertise he has ticked on a list while registering with the service. Sitra as the provider of the service has a more detailed CV at their disposal and keeps this personal information from the eyes of the target companies. The list of twelve expertise areas is similar to the list presented to the companies before applying for the Intro service, which suggests that needs other than purely sales and marketing skills could also be matched when appointing Diili candidates to the companies, but this is not expressly stated anywhere in the documentation.

The factual deal between the "recruit" and the company is done individually in each case, and the compensation for the work as proposed by Diili includes pure equity or equity combined with a small remuneration. Equity itself can be in the form of shares, options or convertible loan, but the work is required to be a full-time job in any case to ensure a proper commitment. Implicitly, this means that the person taking part in the program has to be if not financially independent then at least in a financially robust position as he is "challenged to entrepreneurship" (Laitinen 2003). And indeed, the qualities looked for in Diili candidates include that they have to willing to and able to afford to change their career path (Hallikainen 2003).

By December 2003, close to 50 candidates had listed themselves as interested in taking a role in the Intro companies through the Diili program. In nine cases an "investment" had been realized but there is no data available on the eventual success of these relationships yet. The number is small, but we have to bear in mind that the concept is new and rather "experimental". In these cases, marketing and sales skills have been emphasized, but management skills are also necessary in many positions of this scale. Hence, the possibility of looking for management personnel is not necessarily excluded.

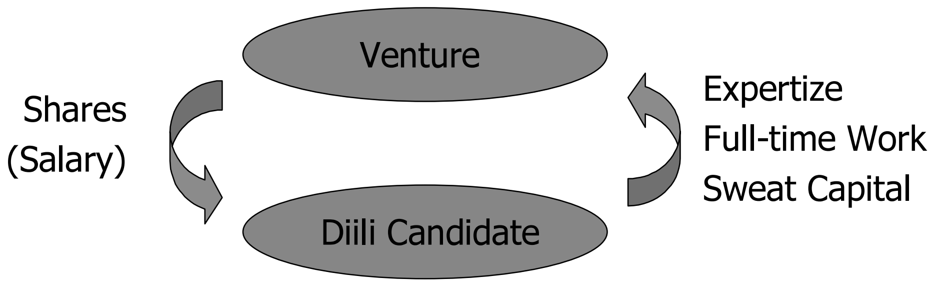


Figure 51. Business Concept of Diili

The business concept above resembles those of the other sweat capital investors, such as Virtual CEO or Source Code Finland presented earlier in this study. Being a *private individual* like a business angel, the Diili recruit *does not invest money*, but still becomes *committed* to the company through ownership given to him in exchange for his work. What differentiates this actor from the two other actors mentioned above is that the Diili recruit is expected to work full-time in the company. Thus he can only commit to one company at a time through this program. Effectively, the purpose is to make the recruit a member of the entrepreneurial team of the company.

### 4.2.11 "Entre Nous" – Mentors for Young Entrepreneurs [14]

The Canadian Youth Business Foundation (CYBF) is a national non-profit organization established in 1996 that assists young Canadian entrepreneurs between 18 and 34 years of age with loans, mentoring and on-line services. According to their own words, they know that mentoring is a key ingredient in helping these entrepreneurs succeed in business. They have two different programs; Entre Nous – where *Entre* is shortened from Entrepreneur – which is mandatory for their loan clients, and an on-line mentoring program called Odyssey – a hint at the origin of the term mentoring in Greek mythology.

The maximum amount of loan available from CYBF is CAN$15,000, with interest-only payments in the first year and total loan period of three or five years depending on amount of loan. The loan recipient is personally liable for repayment of the loan and must work with a mentor for the life of the loan. Thus, it can be considered that the mentor partially takes care of the monitoring function of the investor, being active in corporate governance as a board member or such. Furthermore, the recipient has to have training or experience related to the business to be started, and the business has to be a new, full-time business.

Loan application has to be accompanied with a business plan, after which it is reviewed by voluntary loan committee members. The funds can be released after three committee members have supported the loan and the prospective new entrepreneur has been matched with a mentor. The entrepreneur or entrepreneurs can propose a mentor if they have a suitable candidate available, and if not, one can be appointed for them. Furthermore, the applicants have to attach three references, who will be contacted prior to the loan decision. By June 2003 the program had assisted 1992 young entrepreneurs in financing 908 new businesses with the aid of 312 volunteers in loan review committees.

As for the mentoring programs, *Entre Nous* is a face-to-face mentoring program, and it is not only available for the CYBF loan companies only but participation is in fact mandatory for all of these companies. Each one of the 908 businesses which had received a loan before June 2003 had been matched with a mentor through this program.

The *Odyssey* program is more open, as it is designed for young entrepreneurs who do not require a business loan but still want a mentor. As it is delivered online the entrepreneur and mentor may never see each other face-to-face. Odyssey uses a secure email center for communication between entrepreneurs and mentors. The Odyssey pilot had matched 25 mentors and protégés by June 2003.

In addition to the financing and mentorship activities, CYBF maintains the YouthBusiness.com online community (www.YouthBusiness.com) where young entrepreneurs can view province-specific business news and information as well as also interact with other new or more experienced entrepreneurs. This service, launched on March 27th, 2000, had attracted 4214 members by May 2003 with almost 130 thousand hits during that month.

Regarding the mentoring programs, CYBF promotes five guiding principles adapted from Doyle and Mather (1996) which they also publish in several places on their website (www.cybf.ca):

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[14] This chapter is based on the web pages of Canadian Youth Business Foundation and its mentoring and entrepreneurship programs at www.cybf.ca and www.onlinementoring.ca if not specified otherwise

1. Mentoring is not a service that can be bought, like consulting. The broader emotional and psychological support given by mentors adds to the professional expertise they share with their protégés.

2. Mentoring is based upon receptivity. The best mentoring relationships start with a natural affinity that is felt by both parties and is characterized by similar interests, mutual caring and respect.

3. Effective mentoring involves monitoring. Mentors should meet face-to-face with the protégé at regular intervals to work on setting and achieving the goals of the relationship.

4. Mentoring requires a constant and confidential exchange of information. Mentoring is a two-way relationship - both the mentor and the protégé must agree to hold in confidence the personal and professional information discussed between them.

5. To be a mentor requires both an interest in the protégé's welfare and a certain objectivity. This is why parents are not encouraged to mentor their own children.

These principles are well in line with the discussion on mentoring earlier in this study. Furthermore, they stress that teaming up with a specific mentor or protégé simply because of a shared background or personal views does not guarantee an effective mentoring relationship. Instead, the most critical element is considered to be a genuine interest in learning from each other and a shared commitment to building a solid mentoring partnership – expressions which are again in accordance with our earlier findings.

All in all, CYBF considers its task important for realizing the expectations and ambitions of young Canadians to be self-employed at least at some point of their careers. As the CYBF Chairman of the Board, John Risley, and CEO, Vivian Woytiuk, put it, Canada's young people have become a generation of job makers, not job takers, and consider entrepreneurship as viable a career option as other professions.

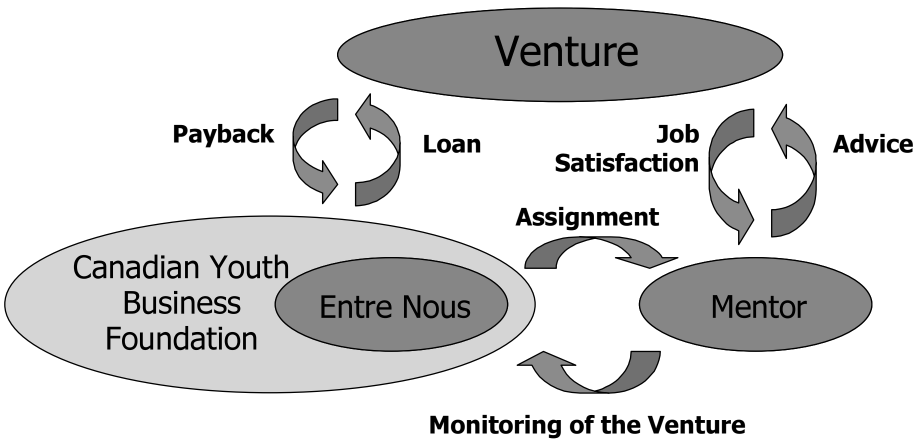


Figure 52. Business Concept of CYBF and the Entre Nous Mentoring Program

As an V2C actor *CYBF* represents a *public entity*, channeling *public funds* to small companies. The funds are not invested on an equity basis but as a loan, so CYBF is *committed* to the success of the company but not as much as it would be in the case of an equity investment. The *Entre Nous* mentoring program is similarly a *public entity*, but only acts as a catalyst at the time of matching the mentor and the mentée. The *Mentors* assigned to ventures are *private individuals*, who commit themselves to assist the venture for a relatively long period. Still, they do this of their own free will, using or receiving *no money*. Therefore, they are effectively *not committed* to the success of the company.

### 4.2.12 "EquityEngine" – an Automated Virtual Incubator

At the end of 1999, the founders of EquityEngine noticed a number of things. First of all, the incubator business was white hot. Secondly, the venture capitalists were craving for deal flow. And finally, there were inefficiencies in the incubator business, which left room for a new model. Thus, EquityEngine was launched in April, 2000 as a matching service for innovators and resources and a virtual incubator for promising business ideas. (interview Stucke)

Three types of EquityEngine programs were offered: Visionary, Resource and Investor. The idea for Visionaries was to submit a 250-word description of the idea, which would then be submitted to the network of Resources and Investors. Resources would consist of those with skills applicable to the development of the aforementioned ideas, such as marketers and accountants, while – stating the obvious - Investors would provide financing for the start-ups when be founded (Bray 2001).

As one writer put it, it was to be a "virtual cauldron where ideas and expertise could be combined into an on-line country kitchen that can cook up a whole range of new cyber companies" (Bray 2001). Kaieteur Institute of Knowledge Management put it in the category "Stockmarket of investment knowledge exchanges" and it was called an automated virtual incubator (Skyrme 2001). Based in Toronto, Canada it also had an office in Silicon Valley, more accurately in San Jose, California and peaked at 18 employees (interview Stucke).

In this scheme, the person with the original idea retains 10 per cent of the equity in the new business once it is launched. EquityEngine takes a 25 to 40% stake and the other people working on it receive a proportion of the equity, based on the time or investment that they contributed. The hypothesis was that even though this means giving away 90 per cent of the ownership of the entrepreneur's original idea, it would be beneficial for many entrepreneurs lacking the resources and skills to do it alone. As one entrepreneur commented: "It costs nothing to submit an idea and you lose nothing by trying it." (Marron 2000)

To serve an even larger community, EquityEngine served not only embryonic enterprises but also those already in existence. Bricks-and-Mortar companies were offered the chance to use the service "to make their transition to the cyberspace". More tangibly, they could submit ideas of their own, use their staff as resources in exchange for equity in the start-up in question, or make direct equity investments. In other words, a company was able to act in all three roles; Visionary, Resource and Investor. According to Brent Stucke, Founder and President of EquityEngine, corporations were indeed important contributors of ideas to the system. Existing online companies were also able to use the service to gain more resources, in which case the amount of shares to be given out was not 90% but "only enough to make it worthwhile for EquityEngine's members to get involved". (Bray 2001)

There are certain unique factors in the EquityEngine concept. As noted by Stucke: "We think this is a spectacular model, simply because capital is so scarce and people are very careful where they are spending money. Now you can get work done in exchange for equity and people have an opportunity to invest without financial risks" (Marron 2000). It is not clear to the outside observer, however, how the system managed the risks facing the Visionary was facing when disclosing his idea to the network: How were his intellectual property rights protected? What if the team made of Resources was not functioning as it was supposed to and the alleged success did not materialize?

In July 2000, two months after the launch, there were 2,300 EquityEngine members reviewing the first 200 ideas, eight of which were expected to go further (Marron 2000). The number of people on board was quite satisfactory but still far away from the targeted 50,000 by year's end (Bray 2001). The partnership network included Hewlett-Packard (Flash Commerce 2000) and the Canadian Youth Business Foundation (Canadian… 2000; see also Chapter 4.2.11), and the concept received much publicity. The press release regarding collaboration with Hewlett-Packard especially was well circulated, resulting in editorials in on-line publications as far afield as in Russia (e-commerce.ru, May 31, 2000) and Japan (japan-internet.com, May 30, 2000).

Still, despite its good and innovative qualities the concept did not succeed. There are several reasons, which may contribute to its demise. First, the timing was bad, as the dot.com boom ended at about the same time as the company was founded. "The market melted down", as noted by Stucke. Secondly, the conditions given to would-be entrepreneurs or innovators were not very encouraging; not only was ownership instantly diluted to one-tenth of the company, but also the risk of losing the idea by exposing it to a wide audience like this was considered a potentially inhibitive factor keeping the best ideas beyond the system's reach (HomeBizNews 2000). Third, the profit model was based on long term income from exists of portfolio companies, which were definitely start-ups in their earliest possible phase. Therefore, a lot of funding would have been needed to keep the system going until the break-even point.

Eventually, the owners decided to convert the company to one offering the virtual workspace they had created - after all, this, together with people, was the most important asset of the company. This was the starting point of the Venngo Network and Venngo Inc. which as of summer 2003 was alive and well under guidance of its CEO, Brent Stucke. At the same time, the equityengine.com website redirects to a service called Smallbizcan, "providing you with a gateway to a business network connecting thousands of businesses with easy-to-use services that reduce costs and help target new customers".

The services offered through the Smallbizcan website include discounts on long distance telephone services, job postings and books. The pages also include the option to register with the service and either post an opportunity or search for one. After registering, the user can e.g. browse the posted opportunities, which are divided into 34 categories. The original expectations of the founders are seemingly not met; the notion of search results being limited to 200 results is far from the fact that there is a total of 28 opportunities posted. Hence, EquityEngine in its original form did not survive. (Smallbizcan, 2003)

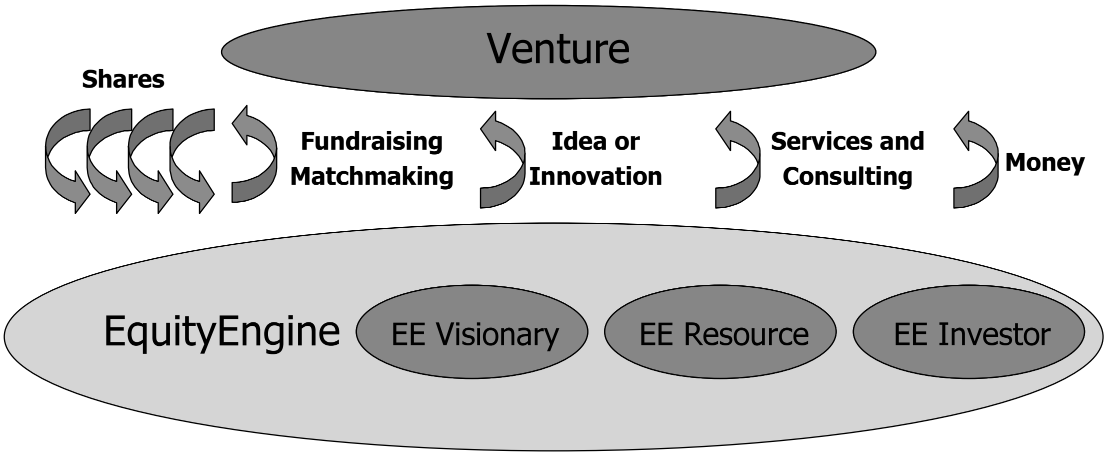


Figure 53. Business Concept of EquityEngine.com

Like many of the cases so far, EquityEngine also pulls together several different classes of actors. First of all, the *EquityEngine Portal* itself, which is a *private entity* becoming *committed* to the target venture through ownership obtained as compensation for services, *not money*. Second, there are the *EquityEngine Resources*, including the Visionaries, who are *private individuals* investing their knowledge, expertise or – in the case of the latter - innovation and hence receiving an equity stake in the company. Therefore, they as well are *committed* to the company even though *no money* is involved. Finally, the group of *EquityEngine Investors* is formed by *private individuals*, who – like business angels – are *committed* to the success of the company by their shareholding obtained by investing their *own money*.

### 4.2.13 "Privanet Capital" – Investment Banking and Brokerage for SME's

During the dot-com era, many different kinds of actors were created to assist the nascent enterprises, and to some extent also exploit the opportunities in them. Bootcamps and matching services, such as Idealab and EquityEngine, are discussed in detail elsewhere in this study. Another interesting actor was Wit Capital, founded in 1996, to be the first Internet-based investment bank, with on-line brokerage services including IPOs and institutional-style electronics trading as the instant after-market (Wit Capital 1999, Frick 1999, WHAFH 2003). In January 2000 Wit merged with the private investment banking firm SoundView Technology Group, which the company is now called (Wit Capital 2000, Soundview 2003).

Privanet Capital, founded at the end of February 2000 by Tapio Niemi and Asko Schrey, was inspired by Wit Capital. Niemi had extensive experience of coordinating investment banking and venture capital both in domestic and international operations, whereas Schrey was the former CEO of the Helsinki Stock Exchange, HEX. They combined their forces to form Privanet: the time was right for an innovative operative to serve small businesses. (Privanet 2003) A study on informal investing in Finland had already suggested establishing a stock exchange for small companies, using the Swedish operative IM InnovationsMarknaden as an example (Suomi and Lumme 1994).

Privanet was to become a versatile provider of services for small, unlisted companies, with fundraising, a "third marketplace" for unlisted stock, investment banking and so on. This led to a problem in the initial phase of operation, as, according to the legislation, not all these activities could be done by the same party. Hence, in 2001 Privanet consisted of three different companies:

- Privanet Securities - The fund-raising arm with both primary and secondary markets for unlisted securities
- Privanet Ventures - consulting, investment banking and business angel services
- Privanet Capital - services such as maintaining shareholder registers and such

From the company's own point of view, the concept of operation and the spectrum of services were said to be unique from the very beginning (Nikulainen 2001). To a certain extent, their services are all unique in the market in which they operate, i.e. Finland, and their marketplace for unlisted securities appears innovative and well organized.

One of the goals was to make an Internet-based marketplace for unlisted securities. This would not only allow the owners of established companies to publicly market their shares, but also provide a secondary marketplace for trading of shares in new ventures. The active over-the-counter (OTC) market has been seen as an important factor improving the formation and growth of NTBF's in the United States (Rothwell and Zegveld 1982).

As this was an innovative approach requiring substantial technology investment, the effort was partially funded by Tekes, the National Technology Agency of Finland. In the original project description, the business idea of Privanet was defined as "internet-centric capital market company that offers new capital raising opportunities and related services of high-quality to privately-held SMEs representing high technology, biotechnology, and other (growth) industries. Privanet also arranges, through its cooperation network, services of outside experts and management consultants to there SMEs." This definition summarizes the operation fairly well in two sentences. The objective of the project was nothing short of creating a stock exchange for unlisted securities intermediating between private equity investors and individuals, offering online broking, new releases of shares and company news services. (Tekes 2003)

The online marketplace is operated by Privanet Securities, open to all registered users free of charge. Fees are collected from realized transactions only, split between the buyer and the seller. Privanet also collects the stamp-duty and forwards it to the taxation authorities, relieving the clients of paperwork of this obligatory task. Close to 50 different securities are quoted on the marketplace, many of them small telephone operators in Finland. The spreads between offered and asked prices are wide. Therefore, Privanet points out that this and the general thinness of the market means that realizing the investment is not always immediate and easy. Nevertheless, through this marketplace it is relatively easy for an individual investor to diversify the investment portfolio to small, unlisted companies without the trouble of actually becoming a business-angel. (Privanet 2003)

New issues of shares are also realized by the same subsidiary, Privanet Securities. The author has personally monitored two cases of this activity, and the marketing has been fairly active, consisting of personal mailings and email, one-on-one investor meetings and in one case also road show (Privanet 2002). The results in both cases have been acceptable from the company side, although the valuation of the shares of the former case has dropped dramatically from the initial offering price. Both of these companies had received private investment from FGIF (see page 157) prior to the issue of shares and before it was merged to Privanet.

Maintaining the multiple licenses from banking authorities required for operating this kind of investment service companies was expensive and burdensome. The change in the legislation in spring 2002 allowed the activities to be pursued under the same roof, thus the two auxiliary licenses were cancelled, Privanet Ventures run down and activities transferred back together again in summer 2002. Another change in the operating environment was expected to occur by the Baltic states joining European Union; According to the founder Tapio Niemi, the licenses – no matter how burdensome to acquire originally – are valid thorough the EU, and Baltic States may provide interesting opportunities for both fundraising and secondary marketplace.

A significant recent change was also the May 2003 merger with the private investment company Finance Group International Finland, FGIF, giving Privanet its own investment portfolio. In the FGIF merger, 60% of the ownership was given to Tanu-Matti Tuominen and Jari Tuovinen who had founded FGIF in 2001. The operating capital for the company came from the 1999 sale of Tietovalta, claimed to be to first new media company in Finland. This may well be true, as Tuominen and Tuovinen founded Tietovalta as early as 1988. By 2003, FGIF had invested roughly €2M in about ten companies and is working actively with the target companies. (FGIF 2003) In fall 2003, Jari Tuovinen of Privanet announced that the name FGIF was to be changed to Privanet Investments, which makes sense for continuity and public image.

In its original form, FGIF could have been described as a two-man business angel company, but as a part of the Privanet group it is now more of a seed-stage investment company operating with its own funds for the time being. According to FGIF founder Jari Tuovinen, the plan is to accumulate €1M in funds and leverage this to enable ten investments of one million each by having Privanet Investments act as a lead investor and underwriter in the private placements. As the investments are to be made from the balance sheet and not from an external fund, dividing the eventual profits to original investors may be legally challenging. (interview Tuovinen)

The array of services offered by Privanet caters for the needs of many objective groups. First, an entrepreneur can obtain assistance in fund-raising in the form of formally organized release of shares, targeted at a group of eligible investors, and create liquidity for the shares of his company by having them listed. More common corporate finance and consulting services are also available. Second, for private equity investors in general, Privanet offers easy entry to a number of at least semi-screened unlisted companies. This lowers the investment barrier and transaction costs. The third, and at the moment perhaps the least important function are the monitoring services offered to both companies and business angels who need to track the performance of the company. (Privanet 2003)

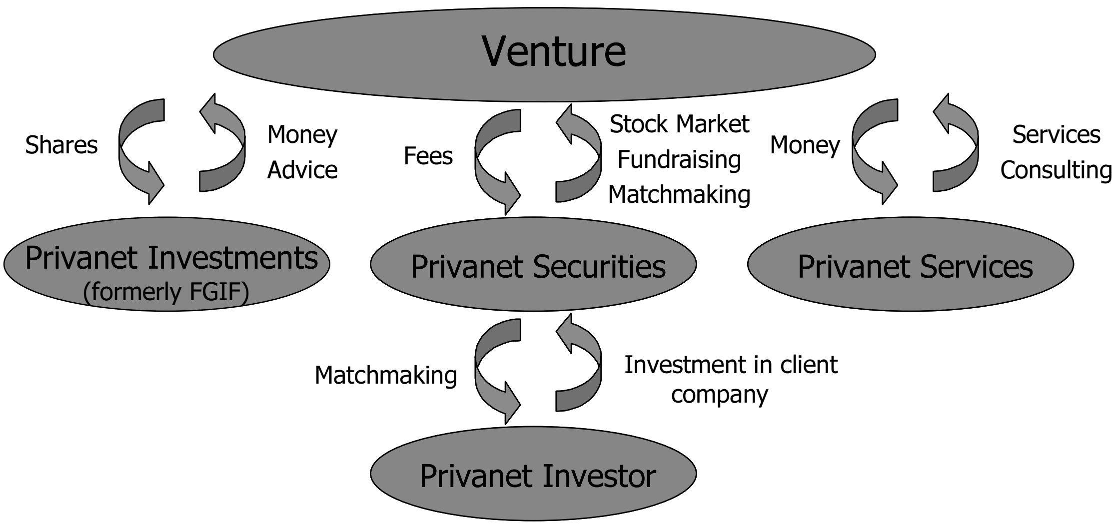


Figure 54. Business Concept of Privanet Capital

There are four distinguishable actors in the preceding case. Of the three private entities forming the Privanet Capital group, *Privanet Investments* in the long run seeks to invest both its *own money* as well as the *money of others* and becomes *committed* to the target venture by the ownership so obtained. *Privanet Securities* and *Privanet Services*, on the other hand, are *paid for* the services they do for the ventures. They also offer services to *Privanet Investors*, which – as in the case of e.g. Intro and EquityEngine investors – are very much like business angels: *private individuals* investing their *own money* and becoming *committed* through ownership. But in contrast to ordinary business angel activity, in this case there is no need for these individuals to meet the target venture or contribute to its operative activities, and the investment can be purely financial.

### 4.2.14 "Idealab" – a VC Bootcamp

In its own words, "Idealab's mission is to turn innovative ideas into successful technology businesses. Founded in 1996 by entrepreneur Bill Gross, Idealab has developed and evolved a process for maximizing the potential of its new businesses. Once an idea is prototyped, Idealab shares with its operating companies its market-tested knowledge, operational support and strategic guidance. Today, Idealab is focused on creating technology businesses based on proprietary technologies that enjoy high margins and have significant potential for sustainable, profitable growth." (Idealab 2003)

This is the company mission of a prolific for-profit incubator, Idealab, taken directly from the company website. It looks similar to many others of its kind, but the company itself is slightly different. It has been said that the Bill Gross pioneered the whole for-profit incubation industry in 1996 by founding Idealab, which had 350 followers worldwide in four years (Hansen et al. 2000) and was soon presented as a business case in textbooks (Skyrme 2001, Coulter 2001). Idealab set the example for the 150 incubators specializing in e-business by mid-2000 (Skyrme 2001), but even as one of them it stands out from the crowd, not only because of the enormous publicity of its successes and failures, but also because of its initial business model based on commercialising the ideas of the founder, Bill Gross.

In 1996, Bill Gross was 36 and had achieved many successes already. A graduate of Caltech, he had always been half scientist and half entrepreneur. He founded his first enterprise, Solar Devices, at the age of 16 while he was still in high school, selling plans and kits for solar energy products. While still in college he sold stereo systems built around a speaker technology he had patented. Later a software company he had with his brother was acquired by Lotus, where he worked for a while until founding Knowledge Adventures, a successful educational software and multimedia company which was eventually sold to CUC International for 100 million in early 1997. (Coulter 2001, Nocera 2001, Idealab 2003)

Apparently, the problem this resourceful individual perceived in 1996 was that there were so many ideas available for development and only one lifetime to implement them as companies. But the arrival of commercial Internet in the mid-1990's finally brought him a vehicle which would give his brain free rein. He could start a company in which his ideas could be incubated and turned into successful Internet businesses. Effectively, he would implement a reversed venture capital concept: instead of raising money and waiting for the ideas to walk in the door, he would generate ideas and then raise the capital from the VC's. (Nocera 2001)

This is more or less what he did. Idealab was founded in Pasadena by Bill Gross and a team of three. As for the incubatees, Citysearch had already been founded the preceding year and others followed: eToys.com, Answers.com, WeddingChannel.com, Tickets.com, NetZero to name only a few of the more successful ones (Idealab 2003). The early successes paved the way for more companies and raising capital was relatively easy. After all, we have to remember that these were the hey-days of Internet boom: the originator of eToys and founder of NetZero and GoTo, both of which went public during next year from their launch, had only nod at the investors to obtain the capital.

During these first years, Gross had fairly strict principles on investing in an idea and was even asked to write an article about his working methods for the Harvard Business Review (Gross 1998). There, he published his thoughts about the “New Math of Ownership”, emphasizing the importance of investing an amount sufficiently small – less than $250,000 per idea - to make the target company aware of the importance of saving money. He also spoke for entrepreneurial spirit, which could be inspired by having the key people own a significant equity of the company – more than 1% per person. In practice, this means that there can be only be less than one hundred of these people, which advocates breaking down economic endeavors into tribes of 100, tribes of owners.

As for the business model and working practices of Idealab, on top of the $250k rule mentioned above, certain rules affected the ideas as well. First, the idea would have to spark off passion among the Idealab executives, so that they would want to work on it and the eventual spin-off based on it. Second, the idea could be changed on the run if necessary. Initially, many companies would be started without a clear business model, but the principle took it that either the Idealab executives or those hired for the company in question would find out the way to profitability later. (Nocera 2001)

To keep the endeavors well financed, capital was raised four times with a valuation of $35M in 1996, $70M in 1997, $170M in 1999 and finally a stunning $9Bn in early 2000, when more than $700M was collected from astute investors like the Kline Hawkins Venture Fund, the Japanese wireless company Hikari Tsushin and Dell Ventures[15]. (Gunther 2002) In retrospect, the last of these rounds seems unbelievable: investors of today no longer expect to get return on investment made on an incubator or a start-up with an entry valuation at $9 billion, not even a serial start-up such as Idealab.

However, as stated those were the days, and the target company was about to go public after its “spin-offs” had just done the same thing: eToys was valued at $7.8Bn on its first day as a public company and the market cap of GoTo.com was $5Bn in November 1999, just months after the public offering (Nocera 2001). Therefore, the investments in Idealab were by no means forced. At least not from Idealab’s side but possibly in fact the other way around: Hollywood talent agents, for instance, told Gross he had to sell them shares if he wanted their clients to work with Z.com, an entertainment site in Idealab portfolio.

Another story is told by the first hire of Gross, now his wife and president of Idealab Marcia Goodstein: When the Dell people asked for more information to complement the standard set they had received, Idealab told them that if they did not feel they had enough information they should not invest, as the offering was oversubscribed. Next day, Dell Ventures wired its $100 million over. (Gunther 2002) The disastrous ramifications of these sloppy due diligence practices will be revealed later in this chapter.

What was different in Idealab, then? One major consideration is that that it not only centered around its founder as a person, but also around his ideas. Most of the business ideas originated from inside the company, and – as it is claimed – in the head of Bill Gross himself. (Economist 2000, Nocera 2001) Looking at his background even before Idealab it is easy to believe this: he was as interested and resourceful as a Renaissance genius. Before the last investment round the company only funded

[15] Depending on the source, the figures on investment and valuation vary slightly.

projects spawned from inside, and this was also the situation in fall 2003. To illustrate this the FAQ sections of the company website can be quoted (Idealab 2003):

Q: “I have a great idea for a business. Can I submit my idea to Idealab?”

A: “At this time, Idealab is not accepting outside business proposals for review. We primarily found and build businesses from ideas that are generated internally. Please check back with us periodically for any change to this status.”

Indeed, the companies spun off the internet incubator called Idealab were originated inside this particular incubator – they were not ideas of the surrounding entrepreneurs. This situation changed for a while after the last investment was called in, as Idealab started funding companies from outside as well. The $250k maximum investment rule was also abandoned, and all in all those hundreds of millions of dollars more or less evaporated in less than a year in funding existing and new portfolio companies and even buying them back in the belief that each and every one of them would be worth billions in the inevitable IPO. (Nocera 2001)

At that time, Idealab had five offices with total of a 250 employees, and its board of directors included Compaq co-founder Ben Rosen and Jack Welch of General Electric. Thus, it could be stated that the human resources were there. But things went gravely wrong. First of all, the money was spent in large chunks on failing projects. Second, the possibilities for IPO, which was scheduled to happen soon after the private placement, melted away when the Internet bubble burst in spring 2000. Third, Gross had unfailing optimism in his own works, and he refused to sell large amounts of stock of portfolio companies which would have allowed the company to gain income – in fact, as noted earlier, he did the opposite by buying back the shares of some of the successful companies at exorbitant prices, trusting the they would be worth more in the IPO. (Nocera 2001)

An example which illustrates how far from reality things were in this center of the Net hubris, is the explanation Gross gave for the cost of new larger offices, contributing to the $6.5M monthly burn rate: “They only cost $1 million a month. If each office comes up with just one $50 million company, they will justify their existence for the year. And I view a $50 million company as a complete failure.” (Nocera 2001) Hence, the assumption was that each office, with or without Bill Gross inside, would every year be able to generate a start-up company worth 50 million dollars, realized supposedly by an IPO.

Not all succumbed to this hubris even at its peak, however. In early 2000, three brothers and a brother-in-law from Montreal moved to Los Angeles to join Idealab and put together an on-line jewellery store. After watching Idealab burn through almost $1 billion the brothers bought back their site, ice.com, taking $600.000 in debt, and headed back to Montreal. From a fresh start in the building where their mother is operating their biggest supplier, Delmar International, they built the profitable ice.com of today. (Olijnyk et al. 2003)

The eventual clear-headedness of these four had apparently been blurred for a while, just as was the case with many others as well. As Pinny Gwinish, VP of Marketing, put it: “We were just riding this wave of euphoria, at a time when there was an obscene amount of money being thrown at the Internet”. To quote their father, a Holocaust survivor who had started a successful local printing company and warned them about the go-big-or-go-home business model of Idealab: “Internet, schminternet!” (ibid.)

To sum it up, the Idealab business model might have worked, but too many things happened at the same time and the company leadership was unable to manage them properly. As of fall 2003, Idealab and its board have recently survived lawsuits by the investors of the last round, who alleged mismanagement and breach of contract. These investors brought the majority of the money but only own 13% of the company. Despite their efforts, Idealab has not yet been dissolved, but the plaintiffs continue their fight as depicted by a website dedicate do inform the shareholders about the status of the lawsuit (www.ilshareholders.com). Nevertheless, according to the judges bad management is not a crime and they therefore have nobody else to blame for losing their investments but themselves. On the other hand, further funding is improbable due to the ratchet clause of the last investment round, when Bill Gross invested $42 million himself on the same conditions as the other investors, a fact which speaks for his sincerity. (Bransten 2002, Gunther 2002, Idealab 2003, Grimes 2003)

Currently, Idealab has gone back to its roots and is again incubating companies sprung off the ideas of Bill Gross. The 18 companies listed on their website in September 2003 range from an easy-to-understand domain registry company new.net and CarDirect.com selling cars online to esoteric promises like Energy Innovations, returning Gross to solar energy, and Evolution Robotics, making a robot which looks like a motorized music rack with a laptop computer. The robot is able to recognize a FedEx package or a $100 bill: “Wow! That’s a hundred”, says the robot. “Would you like to hear more about investing in Evolution Robotics?” (Gunther 2002, Idealab 2003)

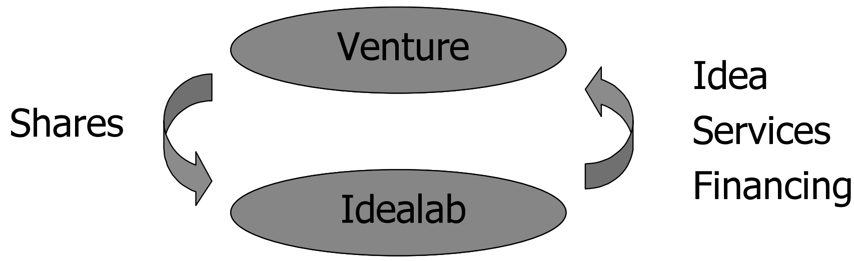


Figure 55. Business Concept of Idealab

Conceptually, *Idealab* is a *private entity* investing the *money of others*, which it has received in the form of equity investment itself. The latter means that the funds can also be considered to be its *own money*, although the investors invested it not to support Idealab but to gain profits in its eventual public listing. Nevertheless, throughout its history Idealab has been *committed* to the success of the ventures it has nurtured, be their origin inside or outside the company.

## *4.3 Characteristics of Emerging V2C Actors*

The fourteen case descriptions presented in the previous chapter yield models for a total of 23 actors, as some case examples may either take different roles (e.g. different Privanet subsidiaries) or include actors on two levels (e.g. Intro portal and investors; or EquityEngine portal, resources and investors). Together with the five traditional classes of V2C actors presented earlier, we have a sample of 28 case examples.

Again, we summarize the key features of the V2C actors in a table, only this time we have reduced the five last parameters of Table 10 to “Commitment”. The actor may be either *committed*, referring to taking an equity stake or success fee as compensation and hence sharing the risk, or *paid for*, referring to being paid for the assistance provided. Furthermore, some of the new actors are partnerships between a public and private partner. These Public-Private Partnerships have been marked “PPP” in the table.

Table 13: Characteristics of New and EmergingV2C Actors

| | *Establishment* | *Organization* | *Source of Money* | *Commitment* |
|---|---|---|---|---|
| Incubator | Public/Private | Entity | n.a. | Paid for |
| Advisor | Private/Public | (Individual/)Entity | n.a. | Paid for |
| Business Angel | Private | Individual | Own | Committed |
| Seed VC | Private/Public | Entity | Others | Committed |
| BAN | Private /Public | Entity | n.a. | Paid for |
| LINC Trial Marriage | PPP | Entity | Public | Committed |
| Virtual CEO | Private | Individual | n.a. | Committed |
| Source Code Finland | PPP | Entity | n.a. | Committed |
| EAccelerator | PPP | Entity | (Own) | Committed |
| UK VC Trust | Private | Entity | Others | Committed |
| UK VC Trust Investor | Private | Individual | Own | Committed |
| University Challenge Fund | PPP | Entity | Own+Others | Committed |
| Venture Stables | Public | Entity | Public | Committed |
| Liksa | Public | Entity | Public | Committed |
| Intro | Public | Entity | n.a. | n.a. |
| Intro Investor | Private | Individual | Own | Committed |
| Diili Recruit | Private | Individual | n.a. | Committed |
| CYBF | Public | Entity | Public | Committed |
| Entre Nous | Public | Entity | n.a. | n.a. |
| Entre Nous Mentor | Private | Individual | n.a. | n.a. |
| EquityEngine Portal | Private | Entity | n.a. | Committed |
| EquityEngine Investor | Private | Individual | Own | Committed |
| EquityEngine Resource | Private | Individual | n.a. | Committed |
| Privanet Investments | Private | Entity | Own+Others | Committed |
| Privanet Securities | Private | Entity | n.a. | Paid for |
| Privanet Services | Private | Entity | n.a. | Paid for |
| Privanet Investor | Private | Individual | Own | Committed |
| Idealab | Private | Entity | Own+Others | Committed |

From the findings summarized above we can find common denominators between different actors, dividing the actors into groups as follows.

**Individual Investor**

The first distinct group of actors consists of *private*, *individual* investors with high net worth or even reasonable income, who wish to make equity investments in small ventures. They invest their *own money* and are *committed* to the outcome in the long run. Hence, we call them *Individual Investors*.

Investments may be done either directly as done by individual Business Angels or indirectly, as done by the investors of VC Trusts. For direct investments, pre-screening and matching services may be used to lower the investment barriers and facilitate co-investments, as done by the investors working with Intro, Privanet and the late EquityEngine. In some cases the Individual Investor takes an active role in the target company as a board member or such, but in many cases the limitations in skills and available time of the investor do not permit this. However, with some of facilitation by other V2C players these limitations are not prohibitive and even small investments can be made efficiently.

**Matching Service**

Second group of actors is formed by *entities* who do *not invest money* but *facilitate investments*. These *Matching Services* come in many forms, which may be *public or private* depending on the maturity and thickness of the market, among other things. In the US and the UK, many Business Angel Networks have been operated for years privately by investors themselves, whereas in Finland the most vivid matching service is Intro, a public entity. Also other variations have surfaced, as proven by EquityEngine and Privanet Securities who make matching on purely commercial basis.

Acting as a catalyst, a matching service does not seek any long-term income but merely endeavors to fund the companies seeking capital by exposing them to suitable investors. They do not invest money themselves, and fund their operation by collecting fees for memberships and services, although some actors also attach a connection to equity ownership, such as the “finder’s stake” of the late EquityEngine and the later-stage investment option of Intro.

**Facilities and Services**

In addition to the offerings of Incubators and Advisors, emerging ventures also need other kinds of services. These *Facilities and Services* are offered by various *public and private entities* as well as *private individuals*, who are *paid for* their contribution.

The services may include assistance in practical arrangements and legal issues of raising capital or maintaining a secondary market for company stock as done by Privanet Securities. Also, matching with mentors and board members as done by Entre Nous and the actual mentoring done by the Entre Nous Mentors fall in this category. In the case of private actors, the services are provided at a price to cover the expenses of the provider as with any commercial operation, and there is no long-term interest outside the period of customer relationship.

**Co-entrepreneur**

A new breed of advisors is ready to share the risk of their clients by taking some or all of the compensation for their work in form of shares of the client company. This makes them *committed* to the client to the extent that they may be called *Co-entrepreneurs*, as their income is tied to the long-term success of the company in question. This actor may be either a seasoned *individual* capable of substantial contribution to the company - as is the case with Virtual CEO or the Diili recruits - or an entrepreneurial *entity* such as eAccelerator or Source Code Finland.

It may be noted that the latter entities are *public-private partnerships* partially funded by public sources and therefore subsidized, as is typically the case with experimental models. It is noteworthy, however, that the private element is needed to enhance the entrepreneurial aspect of these actors. The EquityEngine resources may have been private individuals or entities, but were surely not subsidized, which may have contributed to its demise.

**Pre-Seed Financier**

Certain V2C actors are *public or public-private entities* created for channeling *public funds* to nascent and new ventures, which benefit from the smallish injection of money for development purposes. The goal is usually to pave the way towards an equity investment by seed investment companies or individual investors. These *Pre-Seed Financiers* do not make equity investments, but getting their investment back from the target company is dependent on its success. Therefore, they are committed to their clients even though the clients get limited attention after the active period with pre-seed funder is over.

Examples of these entities include CYBF, Venture Stables, Liksa and Trial Marriage. Many of these models are not even intended to be commercially viable, as they are public initiatives serving strategic interests. Hence, they are capable of taking risk by providing the money with no guarantee of payback, but the risk is of shorter term than with equity investors.

**Seed Investment Company**

Some investment companies are designed and determined to overcome obstacles hindering the large venture capital funds from investing in small companies. These *Seed Investment Companies* are *private or public-private entities* and channel capital invested in their funds by *others* – be they individuals, institutions or private companies - in early-stage companies in small amounts, being *committed* to the high risk and long investment span involved in these investments.

In some cases they use their own money together with money from other sources, thus leveraging the amount of their own funds. This model is followed by Privanet Investments and Idealab as well as University Challenge Funds and VC Trusts in the UK. Also many regional seed VC operatives operate much in the manner described, which is more than natural as the model resembles the classical VC model.

## 4.4 New Typology of V2C Actors

Dividing all the actors identified in the case examples in the previously described six classes yields in the typology presented in Table 14. In this table, the essential characteristics of each class are also outlined. It is noteworthy that the five traditional V2C actors – Business Angel, Business Angel Network, Incubator, Advisor and Seed Venture Capitalist – also fit in the six categories as shown in the rightmost column of the table. The six categories presented can be seen as a new, evolutionary taxonomy of V2C actors.

Table 14: Summary of New and Emerging V2C Actors

| Evolutionary V2C Model | *Characteristics* | Case Examples | Old Classes |
|---|---|---|---|
| Individual Investor | • Private individual<br>• Invests personal money<br>• Long-term commitment<br>• May contribute own time | • Privanet Investor<br>• VC Trust Investor<br>• EquityEngine Investor<br>• Intro investor | Business Angel |
| Matching Service | • Private or public entity<br>• Investment catalyst, not investor<br>• Various compensation methods | • Intro<br>• Privanet Securities<br>• EquityEngine | BAN |
| Facilities and Services | • Private or public entity<br>• Sells various services<br>• Not investor | • Privanet Services<br>• Entre Nous<br>• Entre Nous Mentor | Incubator<br>Advisor |
| Co-entrepreneur | • Private or Pr.-Public Partnership<br>• Entity or individual<br>• Invests sweat capital for equity<br>• Long-term commitment | • EquityEngine Resource<br>• Source Code Finland<br>• eAccelerator<br>• Virtual CEO<br>• Diili Recruit | |
| Pre-Seed Financier | • Public or Pr.-Public Partnership<br>• Allocates public money<br>• Money for development<br>• Strategic interest | • Venture Stables<br>• LINC Trial Marriage<br>• Liksa<br>• CYBF | |
| Seed Investment Company | • Private or Pr.-Public Partnership<br>• Invests other people's money<br>• May leverage own funds<br>• Long-term commitment<br>• Resembles classic VC model | • University Chall. Fund<br>• Privanet Investments<br>• Venture Capital Trust<br>• Idealab | Seed VC |

### 4.4.1 Conclusions and Summary

As a result of the development and the change in the requirements for the V2C actors from the market and the target ventures, new kinds of actors have emerged alongside the traditional ones. These new actors can be divided into six categories as shown in Table 15. The five traditional categories are included in the new taxonomy as shown in the table; for example *Business Angels* are considered to be *Individual Investors*, although not all *Individual Investors* are *Business Angels*. Similarly, both *Incubators* and *Advisors* are considered to be in the *Facilities and Services* category, but they do not form this category alone as there are many other facilities and services available to the ventures than just these two.

Table 15: Traditional and Evolutionary Categorization V2C Actors

| *Traditional V2C Taxonomy* | | ***Evolutionary V2C Taxonomy*** |
|---|---|---|
| | | **Pre-Seed Financier** |
| Seed Venture Capital | ⇨ | **Seed Investment Company** |
| Business Angel | ⇨ | **Individual Investor** |
| Business Angel Network | ⇨ | **Matching Service** |
| Incubator<br>Advisor | ⇨<br>⇨ | **Facilities and Services** |
| | | **Co-entrepreneur** |

The typical characteristics of the actors in each group are presented below.

An *Individual Investor* is a private individual investing his own personal wealth in the target venture. As the shares are usually highly illiquid, this brings him long-term commitment to the ultimate success of the company. He may either contribute own time to the company or refrain from personal involvement, making investments on a purely financial basis.

A *Matching Service* is a private or public entity organizing different means such as databases and venture fairs to match the ventures seeking capital with investors seeking for investable ventures. It acts as an investment catalyst, rarely taking a long-term interest in the venture. It may collect a fee from the parties to the transaction, especially if there are coaching or educating services involved.

*Facilities and Services* consist of public and private entities selling various services. The most prominent members in this group are the incubators and business advisors. Other types of services and facilities which growth ventures may need include marketplaces for unlisted securities, other investment bank services and recruiting of personnel, board members and mentors.

A *Co-entrepreneur* is a private entity or individual, or in some cases a public-private partnership, which shares the risk of the entrepreneur by working for the company for little or no payment. In return for this so-called sweat equity investment they receive an equity stake, which makes them committed to the long-term success of the company.

*Pre-seed Financier* is done by public entities and public-private partnerships. They channel public funds to ventures in the very early stages either as equity or as a loan, making their success at least somewhat dependent on the success of the target venture. Still, operating with public funds their interest is more strategic or social than financial in nature.

A *Seed Investment Company* is a private entity reminiscent of classic venture capital operating with early stage ventures. They invest other people’s money gathered from private and public sources ranging from private individuals to financial institutions. Being equity investors they are committed to the success of the company and are also willing to contribute their skills to the cause.

# 5 DISCUSSION AND IMPLICATIONS

*"'There is nothing more deceptive than an obvious fact' said Sherlock Holmes." – Arthur Conan Doyle*

In this chapter, the contribution of this study is discussed based on the objectives presented in Chapter 1.2. After this, the theoretical and practical implications of the findings are presented in order to improve the existing theory of Venture-to-Capital. The implications include an outline for a normative model of a V2C actor, designed to overcome the deficiencies indentified in the current operatives. The assumption is that using the normative model as a reference point, the current operating models can be developed further, thus improving the target start-up's chances for success. As testing the model is not done within this study, it is presented as a conceptual construction.

## 5.1 Outlining the Contribution of the Study

This study started by assessing the current theory of growth venturing by defining the elements it requires, as suggested in research objective number one. This was required, as every theory of action needs a context to form the platform for it. These four support disciplines - Entrepreneurship, Equity Financing, Ownership and Management – were evaluated in order to find out their key concepts, principles and approach to growth venturing. This effort was done in Chapter 2 and can be seen as first contribution of the study.

The second research objective and contribution is the synthesis to form a unified theory of growth venturing, as done in Chapter 3. Effectively, development of any theory is either up-to-date or lagging. In this case, there was no up-to-date theory explicating the present status of growth venturing. Hence, the state of growth venturing was assessed and synthesized to form a new theory.

When illustrating the empirical reality it was noted, that the existing definitions are deficient when portraying the real actors and practices in Venture-to-Capital arena. Hence, fourteen cases representing new and emerging types of V2C actors were presented and analyzed. As some of these comprised of several individual operatives, this resulted in description of 23 distinct V2C actors. The case study was carried out in Chapter 4 and is considered to be the contribution number three.

Next, the theory of Venture-to-Capital formed earlier was improved by assessing and categorizing the operating models of both prevalent and emerging actors in the Venture-to-Capital arena assessed earlier in the study. The resulting new typology of V2C actors is the fourth contribution of this study and presented in Chapter 4.4.

Finally, as the fifth contribution the theoretical and practical implications of the findings, including a normative model of a V2C actor, are presented next in this chapter.

## 5.2 Evolutionary Trends among the V2C Actors

When comparing the traditional and new business models, four observations can be made as conclusions. First of all, many of the *new actors are combinations of traditional actors* with some new features being tried out. Being a business angel without money or making non-profit corporate venturing inside a university are new variations on an old theme, and time will tell which variations are the successful ones. The successful ones will stay and be emulated, like any other business found profitable. The question is, what are the sustainable key factors leading to success?

Secondly, *contributing intellectual capital* in the sense of sweat capital investment or business knowledge is becoming essential. The present venture capital industry has enough funds to give to those in need, but has drifted away from the early stage companies in both minimum size of investment as well as its capabilities regarding expertise. This is partly due to the fact that venture capital activity is not scalable, when more money is poured in, the number of VC partners and their combined expertise should grow accordingly. This has not happened, thus creating a need for the V2C actors to step in to fill the competence gap.

Next, there should be an opportunity for the *V2C actor also to invest money* in order to make the V2C work as efficiently as possible. Otherwise the financial difficulties and having to concentrate on raising capital will impede the development speed, which in many cases is crucial. This could be imagined to be own money or a fund managed by the player, or even “outsourced” to a robust network of business angels, even though a partnership-like fund as with most VC funds would be the most flexible and therefore the most viable option.

Finally, it can be seen that the trend is towards *obtaining equity interest in the target company*. This has several advantages. First, a new venture has many shares to hand over, but no money with which to pay. Second, the upside potential is highly motivating to the V2C actor– at least as long as the venture looks promising. Third, sharing ownership speaks for the long-range commitment of both parties in question. Naturally, like all coins this has two sides, too: Being paid in equity introduces a need for operating capital and a major business risk to the V2C actor. And in the case of a successful exit, it is the most expensive way of payment for the entrepreneur – who at the end of the day may still be on the receiving end of it.

## 5.3 Outlining the Normative Venture-to-Capital Actor

Probably the most crucial notions from the perspective of the target venture are the quality and level of services provided, and true long-term commitment in the development and success of the investee company. These requirements speak first of all for a professional organization, developed over time, of seasoned, committed experts. Additionally, the requirement of long-term commitment to the success of target ventures strongly suggests that there has to be a vested interest in the company. This commitment can be realized in the form of success fees, but the most intriguing alternative for all parties is equity, bringing the longest and strongest ties as well as the highest upside potential. Furthermore, equity incentive should preferably be extended to the individual executives of the V2C player to promote an entrepreneurial attitude to the business development undertaken in the target companies. The V2C player could be a partnership like the VC partnerships of today, with part of the success flowing back to the partners doing the actual work.

Principally, the task for the V2C actor is to guide the “prospective” company into being an “investable”. The entrepreneur in most cases is doing this for the first time and is not an expert in all the aspects of raising a company. Therefore, the V2C actor should be prepared for activities including working with the administrative issues of the company as well as hands-on involvement in operative issues as needed. It should be able to provide the company with capital either directly from an own fund or indirectly by facilitating an investment from informal and formal venture capitalists. It should also be able to assign expert resources to the company, as both money and expertize are necessary when developing a company. With these resources, both the equity gap and competence gap can be bridged.

As noted above, the optimal V2C player has the capacity to invest seed capital in the target venture. The current *de facto* business model of a venture capital partnership can be used as a starting point. The fund should be big enough to avoid parsimony, but also allow small investments with long time span and high risk. Even if this results in a risk of unsuccessful investments, the approach might do better than screening the companies too strictly, rejecting most proposals and then giving even the most promising companies very little, asking them to "prove their business case" with an investment too small to begin with. Nevertheless, it goes without saying that even if the funds come from government, as in the early days of European VC, the managing partnership should have control over the fund to avoid bureaucracy and to genuinely take responsibility for its profitability.

In addition to the investment fund, the optimal V2C actor should have an ample number of dedicated experts at its disposal. Own staff being very expensive, this would preferably be a network of independent experts, a Knowledge Fund "raised" for the purpose of making intellectual capital investments (Seppä 2002). This portfolio of human resources consisting of individual experts could be created for a set time and managed in a manner similar to the management of financial VC funds. People would enroll to be limited partners and then be assigned to work for suitable companies where their contribution would be most useful. Thus, our assumption is that there would be professionals from universities, executives from corporations and retired entrepreneurs who would give their time and wisdom and act as board members, mentors or advisors for equity compensation. Since these people may be reluctant to leave their positions for entrepreneurship, this could bring them closer to small companies, resulting in "part-time entrepreneurship" and a win-win situation.

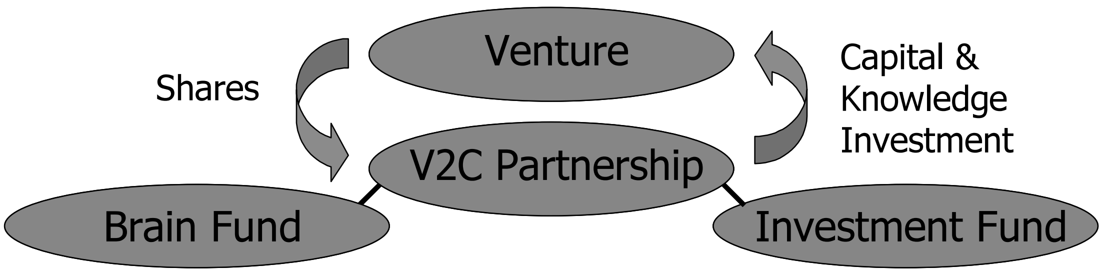


Figure 56. Outlining the Business Concept of Normative V2C Actor

In summary, the optimal V2C actor should be able to make both capital and knowledge investments in the target venture, to accelerate the initial growth of the company. Both the people working with the company and the V2C actor itself should be tied to the target by a vested interest. This commitment could best be done in the form of an equity stake, releasing the venture from the burden of having to pay for business development services and thus freeing the funds to be targeted at other pro-active activities such as product development, organizational development, sales and marketing. And finally, the partners of this delineated V2C actor would have the ambition, entrepreneurship and team spirit needed to work successfully with their target companies, which would – in many ways – resemble their own partnership.

The actor should have an intrinsic, long-term interest in developing the target company. This kind of commitment only comes from having a vested interest in the company in the form of success fees or equity stake. On the other hand, an able V2C actor can increase the value of the company to more than compensate for the dilution effect of its shares. The next paragraphs outline how a Venture-to-Capital actor can organize itself to be able to accomplish all this.

*Organization* – The normative V2C actor is organized the same way as the classic venture capital company. A management partnership company will be set, preferably with one or more individuals as managing partners. The organization will be kept as small as possible, however, and many of the activities are to be performed by the people in affiliated networks to minimize the costs involved both in due diligence and monitoring the investments. Salaries may initially have to be subsidized or paid from public sources, as has been the case previously when new business development models have been introduced, with income from possible service fees and fund management fees to cover at least part of the costs. Eventually, the proceedings from successful exits should enable the operation to grow and be self-sustaining, but this will take years.

*Money Fund* – The V2C actor will facilitate seed investments by putting together an investment fund, a limited partnership, much in the same manner as a VC fund is organized. Money will be raised from institutional investors interested in seed finance investments, public sources interested in regional development and – last but not least – individual investors, who would like to diversify their personal investment portfolio to venture investments but who do not want to become business angels due to the trouble and expertise needed. Venture capital funds may also be potential investors, although the rules of most VC funds prohibit investing in other funds. Trading with the shares of the fund during its running period may be considered, likewise diversifying the preferences in profit sharing between investor classes, although both of these add complexity to the system, which should be kept simple.

*Brain Fund* – In addition to the small seed investment, the normative V2C actor is able to place certain number of experts at the disposal of the target venture. These are members in a “brain fund”, a pool of candidates who have volunteered to act as counselors, board members or advisors in companies which they themselves choose to be in. As compensation for their contribution, which may take years, they receive a minor equity stake at entry, ensuring their commitment to the small number of companies they work with. These individuals may for instance be university professors, business angels, retired executives or active businessmen, all of whom can contribute a limited amount of very valuable time to the venture.

*Deal Flow and Screening* – the deal flow comes from the partner organization, such as public entrepreneurship promotion offices, venture capitalists and business angels as well as those organizations and individuals which have invested in the V2C fund. Proposals are pre-screened by the V2C managing partner and sent to the expert network for screening. If a specified number of them agrees that they would like to invest their time in the company, the venture is deemed prospective and negotiations will be started by the managing partner, with suitable experts taken in the loop as well. If no experts seem interested in the case, there is no future in co-operation and the applicant is informed of the negative decision.

*Syndicating* –In addition to an own investment fund the V2C actor can tap the capital of VC funds and business angels by syndicating investments with them. Both of these groups will benefit from access to pre-screened early-stage companies as well as the managerial attention applied by the brains fund members and V2C actor. This will potentially reduce the minimum investment limit of the VC investors and lower the barriers to becoming a business angel, hence attracting more high-net worth individuals to join the ranks of business angels.

Such a complete solution like this may be well like the philosopher's stone and never become reality. Hence, the ulterior motive of this model is to open the thinking of both practitioners and researchers to new ways of operation by combining elements of traditional and new V2C practices by hypothetically solving all the problems emerging in the literature and field studies.

### 5.3.1 Entry of the V2C Actor

As noted in the summary in the preceding chapter, investment proposals for the V2C actor are expected to arrive from many sources: from public entities, venture capitalists, business angels and investors of the V2C fund. Also, the entrepreneurs may contact the V2C actor or the V2C managers may look for suitable candidates proactively. The V2C managers – i.e. the partners working for the V2C actor - do the pre-screening and preliminary due diligence as in a VC company. When a potentially promising, "viable" company is identified by being found interesting enough by a screening method resembling e.g. that of business angels (see Table 9), it is exposed to all or a limited number of members of the Brains Fund network for evaluation. If a number of them find the proposal promising enough to commit themselves to co-operation, the candidate is deemed "prospective" and further negotiations initiated by the managers.

Specialists and entrepreneurs are introduced and possibilities discussed, followed by business due diligence by the specialists in question. If everything matches and other investment criteria are met, a positive investment decision may be taken and a specialist or several assigned to the company, taking into account the needs of the company and balancing the workload among the specialists. No-one should act in more than, say, three companies in different stages of development at any given moment.

Reverting to the earlier discussion about current actors in V2C space and earlier research done on the VC business model[16], it may be deduced that the new operating model should introduce ownership as an initiative. Hence, at this time a V2C actor will get a stake in the company making it a minority shareholder. This may happen either as a company or as individual advisors, or a combination of both. Shares may be bought at face value or above, depending on the fund mechanism implemented by the V2C actor. As a guideline, the stake might be in the region of 5-20% at this point.

### 5.3.2 Bridging the Equity Gap by Investor Facilitation

When thinking from the traditional VC point of view, early stage ventures are attractive because of their great potential, but the costs of due diligence and monitoring, risk of loss and long investment time are prohibitive. A V2C actor is able to work around the costs and make seed investments by using its brain fund to both screen the investments and monitor them on the long run. The screening and decision process and affiliated costs can be further reduced by standard practices such as those implemented by the University Challenge Funds described in Chapter 4.2.6. Making small investments cannot support more administrative costs than this, but they do not need more: the risk exists but in small investments its overall effect is bearable. Furthermore, both risk and investment time can be reduced by appointing skillful resources from the brain fund.

Placements from the V2C fund may be made either alone or syndicated with other actors, such as business angels and venture capitalists. To follow the classic VC model, this fund should preferably

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[16] Venture capital was found out to be ownership oriented business, not investment oriented by Seppä (2000).

be an external legal entity with limited life span, managed by the V2C actor. The fund does not have to be overtly large, as only seed and start-up investments would be made, and even so the V2C actor could 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 based on at least partial exit plan at VC entry, which – depending on the form of fund and whether the funds would be recycled or not – might also reduce the overall requirement for capital.

The companies in V2C process raise up the level of being big and successful enough to justify an investment, providing deal flow to VCs. But even before this, the VC's can overcome their investment obstacles by working through a V2C office, which can be an agent for the VC company. Knowing that there are committed people who have a genuine, long-term interest spurred by minority ownership in the company, the likelihood of investing may well rise. If the VC can trust the V2C actors and the venture itself to manage the operative aspects of the company, their monitoring costs can be dramatically reduced. These investment can be done via the V2C fund but more likely by co-investing, as the rules of most VC funds block them from making indirect investments through other funds, but whenever seed financing is allowed by the fund and normal capital placement practices are used, then there should be no major legal or administrational hindrances.

There are two notions to be made about the relationship between the V2C and VC actors. First of all, a V2C actor does not compete with VC companies; quite the opposite, it serves the VC community by creating solid investee companies for them to invest in. By definition, it does not invest in those companies which would get VC funding anyway. Secondly, a V2C actor must not be too close to any particular VC company, as this would repel the other VC's and thus be unfair to the investee company, who should be in a neutral position when subsequently seeking for VC financing.

### 5.3.3 Bridging the Competence Gap by Manager Facilitation

As noted in the previous chapters, the V2C actor will team up with a substantial number of managers, executives, advisors and researchers, organizing them as a "brain fund". These specialists in various fields enter the ventures as board members or advisors with a small fee or no fee at all. In return for the time and services they contribute to the company in the coming years, they receive a small amount of shares in the company, which they presumably sell at the time of the VC investment to come. This way the company will have dedicated owner-advisors, co-entrepreneurs, who have a genuine long-term interest in developing the company. And as a win-win situation, many researchers and specialists get taste of entrepreneurship without having to leave their secure full-time jobs.

There is tremendous potential for entrepreneurs in non-entrepreneurs. Traditionally, there have been experts like business angels and business mentors available to entrepreneurs to a certain extent, but it can be argued that more can be done. One resource which can be conveniently utilized by the V2C model are the researchers and professors of universities; they are definitely experts in their fields[17], but unwilling to leave their posts to try and make a career as an entrepreneur. Nevertheless, when any expert could be part-owner and feel the suspense – in a good sense – of entrepreneurship without having to leave his day-to-day job, it might be assumed that good results would emerge.

[17] (sic)

This would also benefit universities by bringing more job satisfaction and interaction with state-of-the-art companies.

As the specialists are introduced to the company at an early stage and they are committed to working with the company for a relatively long period of time, one of the elements of the knowledge gap is already taken care of. Moreover, in contrast with a perhaps financing and growth-oriented board member brought onto the board by a VC company, the specialists in this case 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. Specialists have to maintain their interest in helping the company to overcome the advisor dilemma mentioned earlier. This genuine long-term interest is ensured through modest ownership in the company, transfer of which should be made possible by contractual means if the specialist wants to or has to be replaced during the V2C holding period.

Not having to spend on advisors and board members, the venture will save a lot in company development costs. Still, the V2C process is likely to bring about 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. For this the V2C actor has its own fund and also syndicates with others to make both minor and substantial seed investments. And when the company is grown with these resources it should be eligible for VC investment more rapidly than if operating solo.

### 5.3.4 Bridging the Matching Gap by Owner Facilitation

Both new ventures and private investors suffer from not finding each other. Maintaining good contacts to the active business angel community is of crucial interest to the V2C actor. This can be done by partnering with business angel networks or by organizing such activities if they are not provided by other organizations, as is done e.g. by the public Intro service presented in Chapter 4.2.9. Publicizing this will attract ventures in need of investment, and exposing these investment proposals to business angels will in turn make it worthwhile for them to be affiliated with the V2C actor.

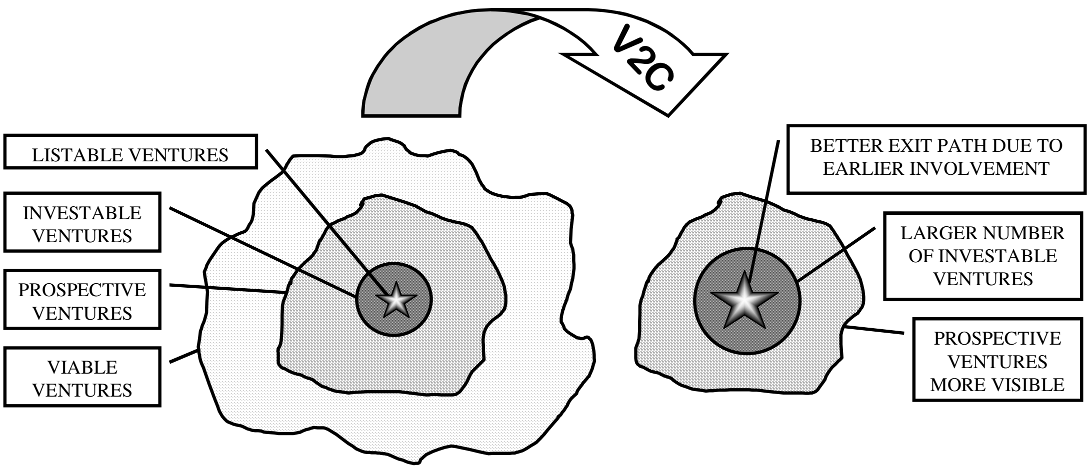


Figure 57: Effect of V2C Activities on VC Screening Process

As seen earlier in Figure 26, start-up companies are laborious to screen and cumbersome to manage, making early-stage financing unattractive for venture capitalists and a burden to business angels. This obstacle can be dramatically reduced by pre-screening the companies, the effect of which is illustrated in Figure 57. 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, as the expectation of the outcome is better.

The V2C fund also brings a highly usable investment vehicle for private investors who want to diversify their investment portfolios to high-risk growth venturing without the trouble associated with full-bore business angel activity, much in the same manner as done by the venture capital trusts described in Chapter 4.2.5. Preferably the shares of this fund can be traded during its operation, bringing welcome liquidity to the investors, although the taxation may pose difficulties if fiscal policies are unfavorable to this kind of investments.

### 5.3.5 Exit of the V2C Actor

As V2C funding is closely related to seed financing, the investment period is unfeasibly long if exit happens when the company is listed or sold by trade sale. Hence, at least partial exit should coincide with the entry of a VC company. This concept is also gaining more support also among the VC companies, as this drawback, from which traditional seed financing is suffering, has been recognized.

Partial exit may not solve the potential problem of a fund maturing before investments have been exited, but will ease the burden of financing the V2C actor itself. If funds are continuous or recycled this will also bring the capital back to the fund for further use. Still, as everyone wants to share the success, a minor stake should be kept until the VC exit to maximize the upside potential.

The VC entry effectively means if not a complete exit for the V2C actor then at least the end of the V2C process. Therefore, at this point the experts will have to negotiate with the venture capitalist about their status in the future and the fate of their ownership stake. Contracts between the brain fund experts and other parties should be designed to cover this situation but not in a manner which might end up as a deal killer without work-around for the investor. In practice, the investors may either wish these individuals to retain their stake, hence saving the money for the purpose intended – company development – or use some part of the money for a partial exit of former owners, thus clearing the field of minority shareholders which might be troublesome in the future. Similarly, the venture and investors may or may not wish to continue having the experts on board after the investment.

# 6 EPILOGUE AND SUGGESTIONS FOR FUTURE RESEARCH

*"The road goes over on and on, down from the door where it began." – Bilbo Baggins*

This study has been an exploration, a journey just like the path of a start-up venture is a purposeful journey from the beginning towards the destionation – a journey of Venture-to-Capital. Due to the exploratory nature of the study the field of interest has been broad, keeping the researcher from going deeply into any particular subject. Hence, many interesting subjects and details are left to be uncovered in future studies.

In many cases the outcomes and conclusions presented in this study seem obvious to the contemporary observer. Yes, it has been noted before that the venture capital field has divided in two, and that fledgling companies are in need of expertise, not merely money. But the main goal of this study is to draw together all the contributions of different disciplines around the growth venture – financing, entrepreneurship, ownership and management – and make them one. By doing this, we make the venture the protagonist, the centrepiece of action. After all, in our findings it is the venture which all the others are using to achieve their goals.

The paths to explore in the future are numerous. As the presented case study sought to create an integrated picture of the Venture-to-Capital actors as a whole, the many aspects of the contribution, profitabilitity and sustainability of their operating models were not considered critically and in detail. This leaves room for further study centering exclusively on the V2C actors, to find out what is the who, why and how of Venture-to-Capital.

One way to learn more about the work of a V2C actor and the V2C arena in general would be to implement the presented normative model in practice and study it by means of action research. This would allow long-term monitoring of the object of study and corrective measures to the model during the research. The practical arrangements and ensuing ramifications are challenging, however: The operation might take years to build to a stabilized level, and even longer to find out the real contribution and quality of the model.

Other suggestions for future research include the selection and performance criteria of the V2C actors, the interrelation and division of work within V2C actors and their relationships to other stakeholders, the ultimate needs of the growth venture and many others. Hopefully the disciplines around the Venture-to-Capital arena will also devote increasing attention to small and growing companies, noting that it is not necessarily the large, public corporations which make the future, but the agile and persistent growth companies, striving to grow up and take their place in the field.

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# APPENDIX: A MODEL OF AN INVESTMENT READY PROGRAMME [18]

One of the instruments proposed for addressing the demand side deficiencies of venture capital is the Investment Ready Programme. The emphasis of Investment Ready Programmes already in place in some countries and counties is on generic information transfer through seminars on sources of finance, practice in presentation with panel feedback and the development of, often self-administered, diagnostic tool to assess investment readiness. This seems to be sufficient regarding awareness, audit and presentation elements but is not enough regarding the critical business support component. One of the reasons for this is that the business development issues are nebulous and generally company-specific, requiring exponentially more assistance and expertise and thus being expensive and time-consuming to deliver. (Mason and Harrison 2002a)

An improved model is presented by Mason and Harrison, who see three distinctive dimensions in “investment-readiness”; Entrepreneur’s attitude towards investment, presentational preparedness and investability of the project in the eyes of external investors. Earlier programs address the two first ones of these but leave the third dimension unattended. Therefore, a five-stage program addressing all the three dimensions is proposed.

First element is the broadly targeted Information Seminar, trying to raise the awareness about equity investment as an alternative source of finance for SMEs and therefore addressing the attitude dimension. The second stage is the Investment Ready Review, in which their suitability to raise equity finance is benchmarked. Those businesses receiving a positive assessment proceed to the Investment Ready Development Programme, intended to address the issues raised by the preceding review. This stage may take months and cover issues such as management team, intellectual property, market analysis and position and so on, hence addressing the third dimension – investability in the eyes of the investor.

Fourth element concentrates on the second dimension by assisting companies to prepare the presentation material to make their investment proposal a winning one, as not providing sufficient information and failing to address the concerns the investors generally have play a crucial role in explaining why many proposals are rejected. The final stage is Investment Networking, where the business which has completed the programme is linked to the potential investors. This last effort specifically addresses the issue raised in chapter 3.2.3 and coined the Matching Gap.

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[18] This section is based on article by Mason and Harrison (2001a)

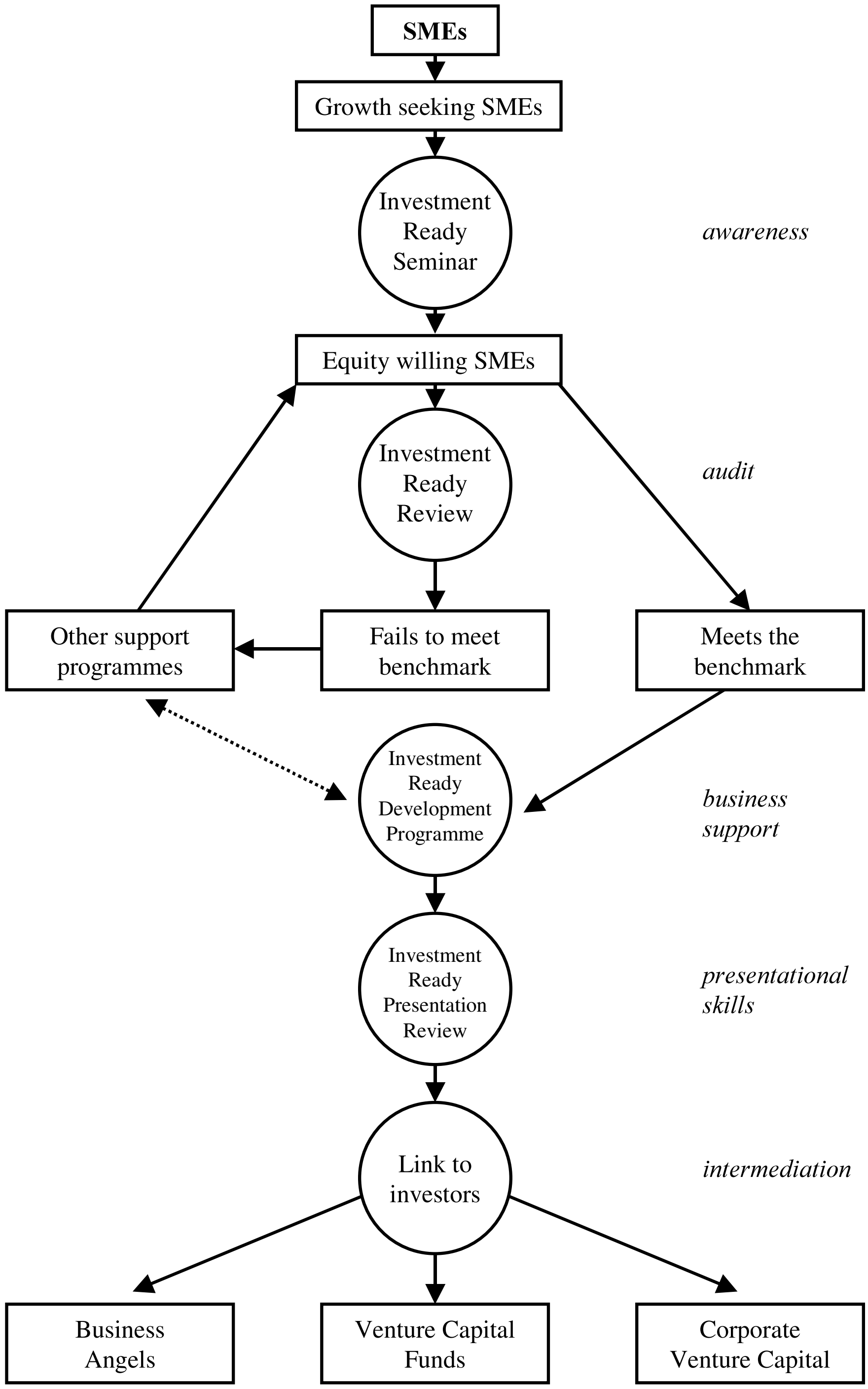


Figure 58: A Model of an Investment Ready Programme

Effective realization of a program like this is not easy, and the authors point out three practical requirements. First of all, the program needs to be long term in order to change the culture and practice. Second, a programme in the presented form will be expensive, and should be heavily subsidized as the target audience can not afford the full costs. Three, for the sake of competence the delivery should be done by consultants and experienced practitioners having good knowledge about the requirements of early stage investors rather than by bureaucrats, or those perceived as such.

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