SCHOOL OF ECONOMICS AND MANAGEMENT
Lund University

Master Thesis
June 2007

Department of Business Administration

How Venture Capitalists can use their Network in order to reduce the Information Asymmetries between themselves and the Venture Management Team

Supervisors

Niclas Andrén

Nils Månsson

Authors

Fredrik Mattsson

Johannes Svensson

Abstract

Title	How Venture Capitalists can use their Network in order to reduce the Information Asymmetries between themselves and the Venture Management Team
Seminar Date	2007-06-04
Course	BUS860 Corporate Finance – Master Thesis, 15 ECTS
Authors	Fredrik Mattsson, Johannes Svensson
Supervisors	Niclas Andrén, Nils Månsson
Key Words	Venture Capital Firm, Business Angel, Information Asymmetries, Network, Venture Capital Investments
Purpose	The purpose of this study is to increase the understanding of how venture capitalists can use their network in order to reduce information asymmetries between themselves and the venture management team.
Methodology	A qualitative approach with semi-structured interviews, consisting of open questions, have been used to receive gradate information in order to reach our explorative purpose.
Theoretical Framework	Our theoretical framework consists of relevant studies made on the dynamics of networks and the problems that can arise in the complex relationship between a principal and an agent.
Empirical Framework	We have been interviewing two venture capital firms and the representatives from two business angel networks. We also made an additional interview with an influential financial actor in order to try to verify our conclusions

Conclusions An extensive network can be used by venture capitalists in order to; verify ventures' technologies, complement the competences in the venture management team, and arrange co-investments, resulting in reduced information asymmetries between themselves and the venture management team. By being structured the venture capitalist can develop an extensive network and thereby facilitate the implementation of these strategies.

Acknowledgements

Making this study has been an exciting journey. We find the contacts that we have had with the business community to be the most rewarding part of our work. It has been really interesting to discuss the area of subject with our respondents. We sincerely want to thank all our respondents:

Cecilia Elofsson, ALMI Företagspartner
Per Heander, Teknoseed
Anders Hättmark, Business Angel Syd
Nicholas Jacobsson, Connect Skåne
Håkan Nelson, Malmöhus Invest

Without your participation our study would not have been possible.

We also want to express our gratitude to our supervisors Niclas Andrén and Nils Månsson. They have contributed to our work with their insights, advice and constructive feed-back.

We would also like to thank Marija Hellström and Daniel Serbinson for your big efforts in proof reading our thesis. Your time consuming work has been a great help to us.

Finally we want to thank each other for making the work with this study to such a stimulating experience. Through times of advancements as well as setbacks we have both always managed to stay in a good mood, encouraging each other, and staying goal oriented at all time. It has been an enriching experience.

Fredrik Mattsson Johannes Svensson

Lund 2007-08-28

Table of Content

1. Introduction ... 7
1.1 Background ... 7
1.2 Problem discussion ... 8
1.3 Contribution ... 11
1.4 Defining key concepts ... 11
1.5 Further disposition ... 13
2. Methodology ... 15
2.1 Selected approach ... 15
2.1.1 Abductive ... 15
2.1.2 Explorative ... 16
2.1.3 Qualitative ... 16
2.2 The interviews ... 17
2.2.1 Selection of respondents ... 17
2.2.2 Implementation of the interviews ... 18
2.2.3 Interpreting and analysing empirical data ... 20
2.3 Method criticism ... 21
2.3.1 Reliability and Validity ... 21
2.3.2 The character of our study ... 21
2.3.3 Interviewers influence ... 21
2.3.4 The respondents ... 22
2.3.5 Literature criticism ... 23
3. Theoretical Framework ... 24
3.1 The Principal-Agent Theory ... 24
3.1.1 Different types of information asymmetries ... 25
3.1.2 How information asymmetries can be dealt with ... 27
3.1.3 Critique against the principal-agent theory ... 28
3.2 Network theory ... 28
3.2.1 The network consisting of contracts ... 29
3.2.2 The network consisting of relations ... 30
4. Empirical Framework ... 34
4.1 Presentation of the respondents ... 34
4.1.1 Malmöhus Invest ... 34
4.1.2 Teknoseed ... 34
4.1.3 Connect Skåne ... 35
4.1.4 Business Angel Syd ... 35
4.1.5 ALMI ... 35
4.2 Presentation of the empirical findings ... 36
4.2.1 Malmöhus Invest ... 36
4.2.2 Teknoseed ... 41
4.2.3 Connect Skåne ... 45
4.2.4 Business Angel Syd ... 49
5. Analysis ... 53
5.1 Verifying the product ... 53

5.2 Have the right competence in the venture management team 54
5.3 Make investments together with other venture capitalists 56
5.4 Build your network efficiently... 59
6. Concluding comments 62
6.1 Our conclusions 62
6.2 Suggestions for further research 63
References.. 65

1. Introduction

In this chapter we start out with motivating the relevance of our selected field. We then discuss research made within this field and what we find suitable for us to look further into. We go through the aim and the purpose of our study. Furthermore we define the key concepts used in our study and present the further disposition of our thesis.

1.1 Background

A society's well being is highly dependent on economic growth and the availability of employment opportunities. By making start-up and growth phases for new companies easier, the evolvement of many new commercial operations can be stimulated. This facilitates not only new employment opportunities and a higher national growth, but also the development of new technologies. (www.nutek.se)

> *"That innovations turn into sustainable business ideas that become commercial companies and that these generate income and create employment opportunities, is a key issue for the future of Sweden."* (www.svca.se)

A very important factor for stimulating the development of ventures, companies in their start-up or early growth phase, is the availability of funding (SCB 2002). In this context the role of venture capitalists, those who invest in companies that are in start-up or early stages, play a very important role. There are two types of venture capitalists, business angels and venture capital firms. Business angels are wealthy individuals and venture capital firms are organized companies, both types invest in ventures. (SVCA 2007) A venture capitalist, not only makes the development of a venture possible by funding it. A study made by Isaksson (1999) shows that companies funded by venture capitalists also have a significantly higher growth than other companies. A reason for this is the contributions from the venture capitalists in form of knowledge and contacts. (Isaksson 1999)

The funds invested in the venture capital market have increased rapidly the last few years. The venture capitalists that are members in The Swedish Private Equity & Venture Capital Association, SVCA, invested 3.1 billion SEK in year 2002 and 6.4 billion SEK in 2006. (SVCA 2007)

Investing in companies that are just started is associated with high levels of risk. Among companies just started, the failure rate is about 40 % in a one year period. (Dimov & De Clercq 2006) At the same time newly started companies that venture capitalists invest in and that do succeed often experience tremendous growth and lead to very high rates of return. (Isaksson 1999)

The large amounts of capital invested in ventures and the high failure rates of ventures, make it crucial for venture capitalists to be able to sort out the ventures that will succeed from those that will not. Since the effects of improving the venture capital investment process are substantial, a lot of research is being made in this field.

1.2 Problem discussion

A well known study that aims to describe the venture capital investment process is Tyebjee & Bruno (1984). In their study they focus on constructing a model that illustrates the venture capital investment process. They also stated criteria, used by investors when screening and evaluating ventures, and their relative importance. The empirical focus in their study was the formal part of venture capital, the venture capital firms. Their work has become a starting point for many studies within the area of venture capitalist’s investment process. However, Tyebjee & Bruno (1984) themselves discovered, when trying to validate their model, that the importance of the quality of the venture’s management team had been underestimated. These findings have been supported by for example Pintado et al (2007). Their results showed that criteria related to the characteristics of the venture management team are very important for venture capital firms when evaluating a venture. These criteria are even more important than criteria related to product and market characteristics (Pintado et al 2007). There are overall numerous of studies, e.g. Muzyka et al (1996), Riquelme & Rickards (1992) and Zopounidis (1994), which point out the importance of a skilful venture management team as crucial criteria for venture capitalists when they screen and evaluate ventures. There have also been studies showing that if the venture is going to be successful or unsuccessful as an on-going concern, is to a great extent determined by the characteristics of the venture's management team, see for example MacMillan et al (1987).

Since the characteristics of the venture management team seems to be very important, in making the investment process successful, it is crucial to have a profound understanding of the relationship between the venture capitalist and the venture management team. The well recognized principal-agent theory addresses the risks that might occur when there are information asymmetries between two different parties with diverging interests. It is well documented that principal-agent related problems are a common phenomena in many different settings, including when venture capitalists invest in ventures. An example of this is Kelly (2001), in his study of business angels. The consequences, if principal-agent related problems are ignored, can take enormous proportions. An example of this is Nick Leeson who caused the collapse of Barings' Bank. Mr Leeson was working at Barings' office in Singapore between 1992 and 1995 and did unauthorized trading in derivatives. He deceived his employer, reporting huge profits when he in fact was causing massive losses. (Drummond 2002). The losses, discovered in 1995, amounted to $1.4 billion. Another example is what happened at Sumitomo Corporation. Their chief copper trader had for a decade been doing unauthorized copper trading causing a $2.6 billion loss. (Mosser 2000) These examples illustrate the importance of drawing attention to these issues.

Tyebjee and Bruno (1984) found that, besides the importance of the venture management team, it is important to have an extensive network. To have this is common for venture capitalists, since it is a beneficial resource. For example Tyebjee & Bruno (1984) emphasize the importance for venture capitalists to have an extensive network in order to initiate contact with different ventures. Many venture capital firms also explicitly state that they make use of an extensive network in order to make their investment process more efficient.

"EQT's industrial approach is built upon experience and networking" (www.eqt.se)

> *"InnovationsKapital has an extensive network of relevant industry contacts that can provide significant assistance and advice."* (www.innkap.se)

> *"Our wealth of experience in strategy, operations and management, as well as our extensive international network of relationships across the sector, enable us to work with managers to develop, support and execute their business plans."* (www.ingeniousmedia.co.uk)

Since an extensive network is a striking feature for venture capital firms, it is a suitable area to study. We want to, by using a qualitative approach, look further into how venture capitalists, consisting of venture capital firms and business angels, can make use of their network in order to reduce information asymmetries between themselves and the venture management team of the ventures they invest in. By studying both of these types of venture capitalists, we hope to get a more gradate view over this phenomenon, than we would have achieved by just studying one of them.

The venture capitalists' network, that we expect to facilitate a reduction of the information asymmetries between themselves and the venture management team, can consist of both informal and formal contacts. The distinction of a network in this study is very wide, and includes for example former co-workers, business partners, and other types of business contacts and informal contacts.

Our purpose is to increase the understanding for how venture capitalists can use their network in order to reduce information asymmetries between themselves and the venture management team.

In summary: We will use principal-agent theory and network theory as our theoretical framework to try to better understand the complexity that surrounds the relationship between the venture capitalist and the venture management team, and how the venture capitalists network can be used in order to reduce information asymmetries. In order to hopefully get a gradate comprehension of the problem we will make use of a qualitative approach, and study both types of venture capitalists, venture capital firms and business angels.

1.3 Contribution

We have when using traditional economic theories; principal-agent theory and network theory, concluded that they are insufficient to efficiently capture how venture capitalists, by using their network, can reduce information asymmetries between themselves and the venture management team. To better capture this phenomenon we have found out that our theoretical framework should be complemented with theories that have a more behavioural focus, e.g. psychological and sociological theories. This master thesis gives valuable guidance for a suitable theoretical approach when studying this subject.

We have been able to present a few different strategies of how venture capitalists can use their network in order to reduce information asymmetries. Hopefully, when implementing our strategies, the investment process can be carried out more efficiently, since our strategies will result in less information asymmetry and thereby reduced risk.

1.4 Defining key concepts

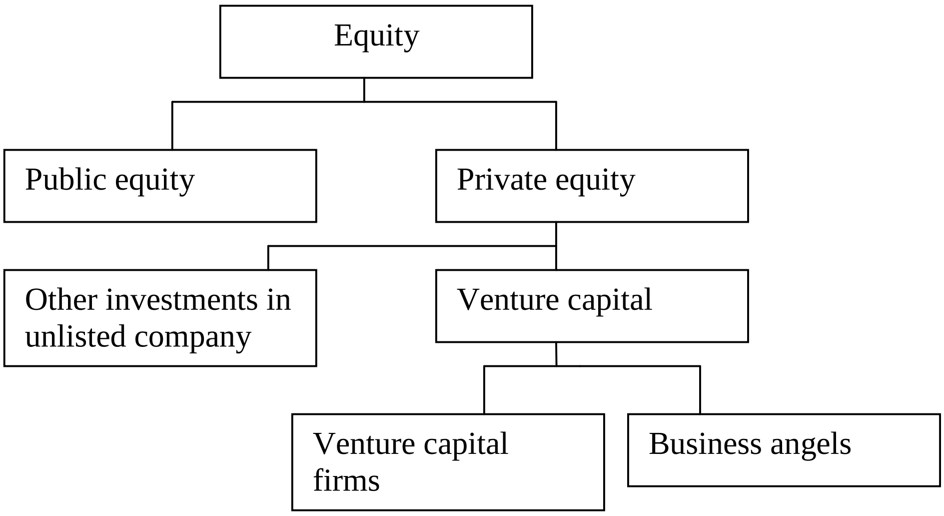
Venture

A venture is a non-listed company that is in the start-up phase or an early growth phase. (Isaksson 2000)

Venture management team

The venture management team consists of the innovator/entrepreneur managing and running the venture. It is in this study also implied that the person/persons in the venture management team also are the founders and initial owners of the venture. Throughout this thesis we consistently use the term “the venture management team” even in those cases referring to a single person.

Different types of equity



Source: Lindholm, Teknikbaserat nyföretagande (2004), p. 288

Venture capital

Venture capital is equity that is invested in ventures (Lindholm 2004).

Venture capitalist

A venture capitalist is an actor that invests in ventures. There are two different types of venture capitalists, business angels and venture capital firms. (Lindholm 2004) When we throughout our study use the term “venture capitalist” we are referring to a venture capital firm or a business angel.

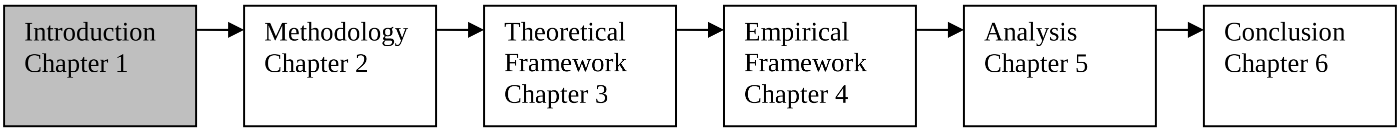
Venture capital firm

A venture capital firm is a formal organisation, which invests in ventures, and their capital is sometimes called formal venture capital. They normally have a limited time horizon when it comes to the ownership of the venture and plan to exit the venture within a certain period of time. Venture capital firms take on an active role in the ventures they invest in. They contribute to the venture with their capital and competence, and are usually represented in the venture’s board of directors. The venture capital firms normally have a portfolio of investments consisting of different ventures, and the ventures that they invest in are usually companies with great business opportunities. (Lindholm 2004)

Business angel

Business angels are wealthy individuals privately investing in ventures and their capital is sometimes called informal venture capital. Many business angels have a history as successful entrepreneurs (Osnabrugge 2000). They can therefore, in addition to money, often contribute with experience and contacts. Their main focus is to make money, but usually they also have personal reasons why they want the company that they invest in to be successful. Usually a business angel is making a much smaller investment compared to a venture capital firm and is most likely to invest in the start-up phase or seed phase. It has during the last years emerged networks of different business angels that invest together, making the structure look more like that of a venture capital firm. (Lindholm 2004)

1.5 Further disposition



In chapter 2 we describe the methodology we have used when making our study. We describe the different choices we have made throughout the study, and motivate why we have made these choices.

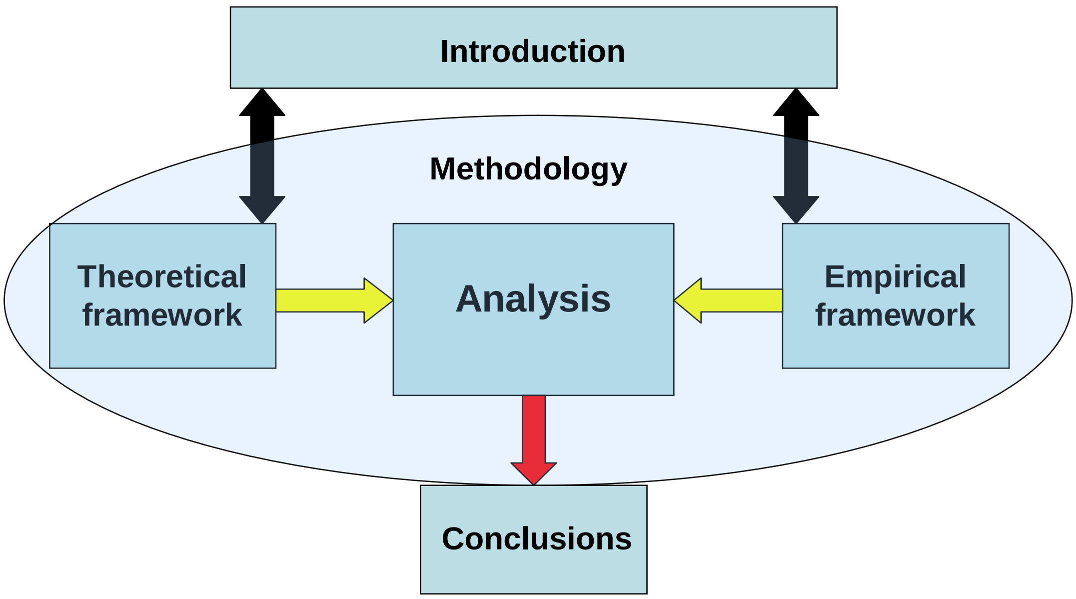
In chapter 3 we go through our theoretical framework. We describe the theory that we use as a knowledge foundation for our study. We map out some of the studies that are relevant for the theoretical perspective in this study.

In chapter 4 we present our respondents and we compile our empirical material that we have gathered through our conducted interviews. The information is presented respondent by respondent.

In chapter 5 we evaluate the gathered empirical information and analyze it by using our theoretical framework. We also try to test our findings by having a verifying interview.

In chapter 6 we present the conclusions drawn from the analysis of the gathered information. Here we also give suggestions for further studies.

Below is an illustration of how the different parts of this master thesis interact with each other.



2. Methodology

In this chapter we describe our methodology used and the choices we have made during the course of this study. We go through how the process of collecting data was undertaken and we also discuss potential shortcomings of our research methodology.

2.1 Selected approach

2.1.1 Abductive

The two main different methodology approaches are deductive and inductive. The starting point in a deductive approach is a certain theory. The accuracy of this theory is then tested empirically. In an inductive approach on the other hand the empirical findings are used to try to formulate a new theory (Jacobsen 2002). Our study is deductive in the sense that we have a knowledge base in existing theory. We therefore had a set of expectations on what results we would find in our study, and that influenced how we initially formulated our questionnaire. On the other hand we have searched for information that could give us indications that existing theory might need to be slightly adjusted or complemented. During the course of our information gathering process, we have updated our questionnaire to also cover newfound relevant insights that we have come aware of through our conducted interviews. Thus we also have an element of an inductive approach in our study.

When combining these two different approaches we end up in an abductive proceeding. The research is conducted through an alternation between the theoretical and the empirical perspective. This is especially suitable in a case like ours, where we want to come to new insights and get a better understanding for our studied area of subject. (Alvesson & Sköldberg 1994)

2.1.2 Explorative

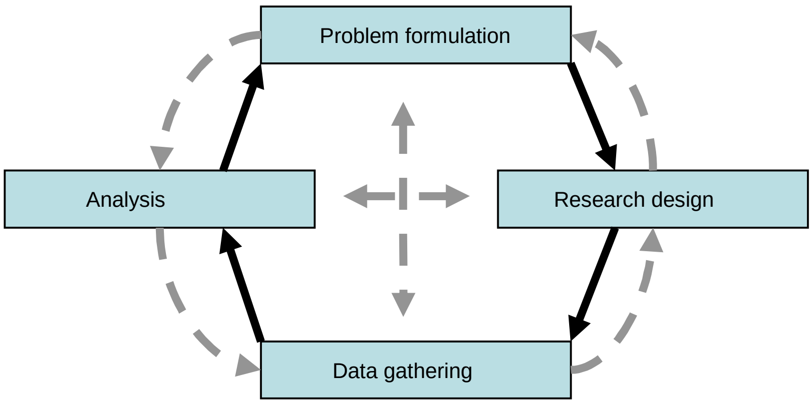
The purpose of our thesis is to increase the understanding of how venture capitalists can use their network in order to reduce information asymmetries between themselves and the venture management team. The problem we are studying is very complex, and the results we are looking for are relatively unknown when we start our study. In a setting like this it is suitable to use a very flexible and open approach. (Jacobsen 2002) Since we want to come to new insights, and thereby increase the understanding of our studied problem, our approach can be characterised as being explorative.

2.1.3 Qualitative

This master thesis handles a very complex issue that is difficult to quantify and therefore the qualitative approach is very suitable. We do not want to limit the respondents by asking them to grade or rank a pre-defined set of factors. Instead we want the respondents to be able to give us their individual perception of networks and problems related to principal-agent issues. In this way we can come to new insights and potentially become aware of notions not previously thought of. This is preferably achieved by using qualitative methods where the respondents can speak about the area of subject with as few constraints as possible. We have therefore decided to gather our empirical information through semi-structured interviews, consisting of face-to-face interviews and a telephone interview, with open questions.

The progress of our study reminds of the way Jacobsen (2002) describes that qualitative research often looks like, an interactive process, see figure below. After every interview we go through the gathered information and revise and update our set of questions, our problem formulation, and research design, if necessary. We do this when we get information that makes it possible for us to improve our study so that we better can fulfil our purpose, i.e. when a respondent gives us ideas not thought of, we discuss that notion during the interviews that are still to come. When we have conducted our interviews, made the analysis and drawn our conclusions, we also test our conclusions by interviewing an additional respondent. In this way we determine if we can verify our conclusions.

The qualitative research as an interactive process



Source: Jacobsen, Vad, hur och varför? (2002), p. 143

2.2 The interviews

2.2.1 Selection of respondents

Since venture capitalists consist of venture capital firms and business angels, we wanted to interview representatives from both of these different types of investors. By interviewing both venture capital firms and business angel representatives, we were hoping to receive a more gradate set of information since the problem will be highlighted from two different perspectives.

When selecting the respondents we had a set of criteria that we wanted the respondents to fulfil. We wanted them to have a connection, in some form, to Lund University and thereby be known to us, at least by name. Their connection to Lund's University gives them an inherited legitimacy. Another important criterion was that the group of respondents was geographically located in our vicinity which made it easier to conduct face-to-face interviews and, if necessary, conduct follow up interviews. With a qualitative research method with individual interviews it is also suitable to keep the numbers of interviews low, since you quickly will get so much information that it will become preposterous to manage it otherwise (Jacobsen 2002). We have therefore narrowed down our study to only cover two venture capital firms, two business angel network representatives and one final respondent that will determine if we can verify our conclusions or not. This makes it possible for us to more thoroughly analyze a few objects, hence having a more intensive than extensive approach. Studies with a narrow focus can be appropriate when you want to find ways to improve existing theory. By analysing few units thoroughly we can increase our chances of finding information that earlier has not been obvious. (Jacobsen 2002)

When it comes to the venture capital firms selected they are slightly different from each other, in terms of owner structure and organisational structure. This increases our chances of, not only to confirm information, but also to receive supplementary information. Furthermore, we wanted the representatives from the venture capital firms to have extensive experience from their business area, and thus hopefully have great insight in the problem area we are studying. The two venture capital firms chosen are well established and prominent in southern Sweden.

The business angels are difficult to get in contact with and that is one reason why we have decided to interview the representatives from the two major business angel networks in the region instead. Another reason for choosing a business angel network representative instead of a business angel is that it is unlikely that a business angel will have a track record of investments as extensive as that of a venture capital firm. A business angel's information is therefore believed to be limited to only a small number of venture capital investments made by him or her. The business angel network representatives on the other hand probably have experience from closely having followed several different business angels and their investments made in ventures. We therefore hope that by instead interviewing the representatives from the business angel networks, we will get a more gradate view.

For our last respondent, that we interview to determine if we can verify our conclusions, our criteria were different. We want to interview an organisation that operates on a national basis, is well established and has experience from investments in ventures.

The respondents that are chosen are presented in chapter 4 – Empirical Framework.

2.2.2 Implementation of the interviews

When constructing our interview questionnaire we have decided to use very open questions. We did this in order to let the respondents answer with their own words, and thus hopefully increase the chances of getting new information, that we had not thought of when formulating the questions. By allowing the respondent to lead the conversation in the direction of his choice, to a certain extent, we hope to be able to capture what he finds most important and relevant. In order to reduce the risk for getting biased answers, we do not reveal the exact purpose of the study, but instead use very open questions about the area of subject in general, e.g. how is the investment process conducted. Open questions are especially suitable in a case like ours, where the interviewer has limited experience and knowledge from what is studied, and when searching for new information within an area. (Bryman & Bell 2005) Even though we have open questions, we use a checklist in order to secure that all our main topics are covered and discussed with the respondents. The discussions are kept very flexible and the order in which the topics are discussed varies from interview to interview when necessary, in order to get a natural flow in the discussion. Thus, our interviews are semi-structured. (Jacobsen 2002)

The last interview differs to some extent from the other interviews. In order to discover, if Mrs Elofsson can verify our conclusions, we first ask her to discuss the components of our analysis in a general way. The reason for this is that, if we only present our drawn conclusions, she might tend to just agree with our conclusions. We therefore, not until the end of the interview, explicitly ask her if she agrees with our drawn conclusions. In this way her answers will probably tend to be in line with her previous reasoning, thus reducing the risk for biased answers.

When executing the interviews we first had scheduled an appointment with the respondent and given information about the main topic of the interview. This was done in order to make sure that the respondents had set aside enough time for the interview and give them the opportunity to prepare themselves. The face-to-face interviews are undertaken in the respondent’s office, in order to make the interview as convenient, and time efficient, as possible for the respondent. Both of the authors are always present at the interviews in order to complement each other during the discussions. To be two interviewers also makes it easier to take relevant notes during the interviews.

To further ease the transcription and managing of the gathered information we use a recording device during all our interviews. This allows us to be more focused on the discussion and less on taking notes. This often makes the interview proceed in a more natural way. (Jacobsen 2002) There is always a risk that the respondent will feel uncomfortable, restricted and more careful of what he says when there is a recording device present. (Bryman & Bell 2005) In order to try to avoid this problem we are always careful about asking if it is okay that we are using the recording device. After the interviews we, as quickly as possible, write down the information gathered in order to, as far as possible, also be able to capture information consisting of our visual and emotional impressions that we got during the interviews.

Respondents normally feel more comfortable with revealing sensitive information during a face-to-face interview than during a telephone interview. The reason for this is assumed to be that you are able to get a more personal contact, since you can have eye contact with your respondent. It is also easier to become entrusted with each other when meeting than when talking through an impersonal media like the telephone. (Jacobsen 2002) We therefore try to as far as possible conduct our interviews face-to-face. Only once, when the respondent is unable to meet in person, we make use of a telephone interview. The telephone interview is also recorded. This is made possible through the use of a speaker phone and a recording device. The speaker phone also makes it possible for both authors to participate in the interview.

2.2.3 Interpreting and analysing empirical data

Interpreting and analysing qualitative data can differ a lot between different researchers and it is not a task that is easily conducted.

> ***"…***_analysis and interpretations in qualitative research are neither simple nor uniform. The diversity in this area is so important and so well founded that it is almost impossible to integrate it into one model, pattern or template. […] qualitative research analysis and interpretation are pluralistic…"_ (Sarantakos 2005 p 352)

The information that we gather from our interviews is deconstructed and placed in different subject categories, e.g. how to efficiently maintain a network. We then compare each respondent's opinions on each subject category to see if we can detect consistencies. With the knowledge accumulated in our theoretical framework we sort out the consistencies we find most interesting in the view of our purpose. We then discuss and elaborate further on these to be able to stipulate conclusions that help to fulfil our purpose. We then try to verify these conclusions by having a final interview.

2.3 Method criticism

2.3.1 Reliability and Validity

The study is reliable if there are no or few haphazard or circumstantial stipulations that are affecting the outcome of the study. The study is valid if it is measuring what it is intended to measure. (Bryman & Bell 2005) These definitions of how trustworthy and accurate the results of a study are can be difficult to apply on qualitative studies (Bryman & Bell 2005). We therefore describe the risks that we have come aware of and how we try to manage them. We present this together with general criticism against our study.

2.3.2 The character of our study

Our research approach is qualitative and there are several critiques raised against the qualitative approach. It is often accused of being too subjective because the results are products of the researcher's unsystematic interpretation of what is important. Furthermore, the close relationship that tend to emerge between the researcher and the respondent is contributing to the problems with subjectivism, e.g. the interviewer might get unwilling to bring forward information that would put the respondent in a bad light. Another concern that is often raised against the qualitative approach is the fact that it is usually not possible to replicate a qualitative study. In addition, it is considered by its critiques to merely being a random sample from a population and that the findings can not be generalized on the population as a whole. (Bryman & Bell 2005) There is a risk that we are too subjective, since we can not be completely objective, when interpreting and analysing our gathered information. We try to avoid clinging to preconceptions, but instead try to be open-minded and thereby receptive for new perspectives and apprehensions. We have also try to stay as neutral as possible, when interviewing respondents as well as when interpreting the gathered information, in attempting to minimize the effects of our own values and attitudes.

2.3.3 Interviewers influence

We try to reduce our potential influence over the respondents by trying to give a neutral impression. We show our interest, but we try to not judge or to put values on the information that we receive from our respondents. As far as possible, we also try to blend in into the respondent’s environment, e.g. by trying to dress in a style similar to theirs. Furthermore we are always careful of how we present our questions. We try to keep the questions as open as possible and we try to not give hints of what kind of answers we are expecting. Since it is practically impossible to eliminate the interviewers influence over the respondents entirely, this study might be difficult to replicate. Thus, if our study is tried to be replicated, there might be slight variations in the gathered information. The conclusions that are reached, however, would most likely be similar to ours. The criterion for a study to be fully replicable is generally difficult to fulfil in qualitative studies, since the social environment is constantly changing. (Bryman & Bell 2005)

2.3.4 The respondents

There is a risk that the respondents give us biased information. The respondents might get the feeling that they are being evaluated and therefore want to bring themselves, and their organisation, forward in an as positive way as possible. There is also a risk that the respondents give us the information they think we want to hear, rather than the true information. This is difficult to prevent, but we aim to create a comfortable atmosphere with our respondents. We also avoid revealing the exact purpose of our study, since this probably will increase the risk for the respondents to give us the answers they think we want to hear.

A potential drawback with having the representatives of the business angel networks as respondents can be the fact that they do not have experience from investing in ventures themselves. In that sense the information they give us is of second-hand character. They will refer to information given to them from business angels they have been in contact with. However we assume that they as representatives of the business angel networks can give information with a satisfying closeness to the studied phenomenon, since they have followed and talked to many business angels.

There is also a risk that the respondents’ opinions are not aligned with the opinions of their organisation as a whole. This might especially be a problem with our final respondent, which we use to determine if we can verify our conclusions, since this respondent will be part of a large organisation that operates nationally.

2.3.5 Literature criticism

It can sometimes be difficult to verify the validity of articles, theses and other documents. We are careful about considering, where the documents come from, and in what context they have been written. Most of the literature use is written by researchers at universities around the world. We also try to verify the reasoning in a document by looking at several other documents in the similar field. Furthermore we only make use of literature of which we feel we have reached a profound understanding of its implications, thus reducing the risk for misinterpreting the information and draw incorrect conclusions.

3. Theoretical Framework

In this chapter we go through our theoretical framework consisting of two main theories, principal agent theory and network theory. This is where we accumulate a knowledge base that is to be used for gathering, interpreting and analysing information.

3.1 The Principal-Agent Theory

Normally, at least initially, the venture management team holds more information than the venture capitalist and this information advantage can be exploited by the venture management team. There is an information asymmetry between the venture capital firm and the venture management team.

This is a type of problem that the principal-agent theory addresses. The basic idea behind this theory is that it is a principal that is hiring an agent to perform a certain task. (Bengtsson & Nygaard 2001). The starting point in this theory is that informed people take advantage over people who are uninformed. It is the agent that is the informed party and the principal that is the uninformed party (Husted 2007). There are a few assumptions underlying this theory:

- Both the principal and the agent are utility maximizers
- There is a goal conflict between the principal and the agent
- The information between the principal and the agent is asymmetric
- The agent acts opportunistic
- The agent acts with limited rationality
- The agent is risk avert

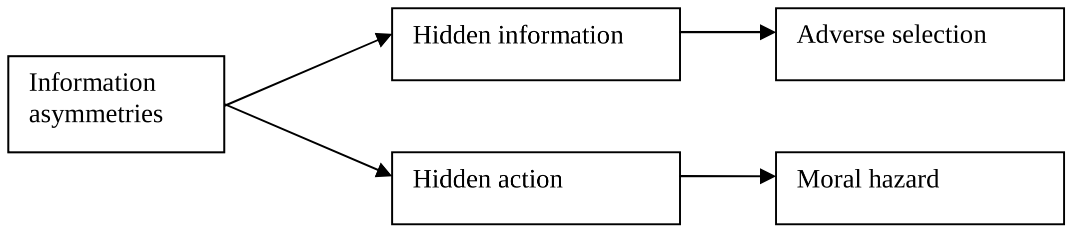
(Bengtsson & Nygaard 2001)

When it comes to venture capital investments, the venture management team can be seen as the agent and the venture capitalist as the principal. There are several ways of how the venture management team can act in a self-serving way. The venture management team might choose to start developing a project that is economically unjustifiable because they have a passion for the project or because they are emotionally committed to the project. Another problem is that they might choose a low-risk, low value strategy because they, in many cases, have a large part of their personal wealth tied up in the project. Venture capitalists are likely to prefer a high-risk, high-value strategy since they tend to be wealthy and well diversified. Another example of a self-serving behaviour from the venture management team can be if they unjustifiably continue a project. One explanation for this can be the fact that as long as the project continues, the venture management team gets paid. Another reason might be that a psychological fixation could cause the venture management team to unconditionally stick to the project and thereby not make any rational assessments of the prospects of the project. (Ogden et al 2003)

The information asymmetries that are the underlying problem in the principal-agent theory can come in different shapes and these will be dealt with in the next section.

3.1.1 Different types of information asymmetries

Adverse selection and moral hazard are very relevant when it comes to venture capital investments (Amit et al 1998). This study will be focused on the information asymmetries between the venture capitalist and the venture management team. Below is a picture that is illustrating the different parts of the information asymmetries that will be dealt with in this study.



Information asymmetries come in two major forms; hidden information and hidden action. When one party has relevant information that is unknown to the other party, there is hidden information in the transaction. A situation when this could occur is when the venture management team is developing a product. They probably have a very good idea if the product will work or not, compared to the venture capital investor who is financing the project. A venture management team has normally incentives to overstate the advantages with their product. The hidden information problem makes it hard for the venture capital investor, especially if the market consists of many low-quality ventures, to separate high-quality ventures from low-quality ventures. Difficulties in separating these ventures leads to a phenomenon called adverse selection. (Amit et al 1998) The term adverse selection is stemming from the insurance industry. It was used to describe that particularly risky individuals tended to be attracted by a specific kind of insurance, e.g. a smoker might be more prone to buy a health insurance than a non-smoker. (Husted 2007) An additional example of a situation when adverse selection might occur is when an employer cannot judge whether a research scientist applying for a certain job has the claimed experience or not. (Eisenhardt 1989) A fairly lengthy discussion about adverse selection can be found in Akelof (1970).

Hidden action is about one party not being able to observe relevant actions that are taken by the other party. It is for example unclear whether the venture management team is working hard and making sound decisions in favour for the venture or if they plan to steal the venture capital investor’s money. This problem is known as moral hazard. Moral hazard is about when an informed party has incentives to act out of self interest even if the costs of these actions are high for the other party. (Amit et al 1998) An example of moral hazard is when a research scientist is conducting research on a personal project on company time, but the tasks that the scientist are conducting are so complicated that his superiors can not detect it. (Eisenhardt 1989)

In addition there is another problem stemming from information asymmetries and that is what is usually referred to as hidden intentions. This is a situation when the principal knows about the opportunistic behaviour from the agent, but is not in the position to prevent it. This problem arises when irreversible investments have been made by the principal. He or she is then dependent on the agent and costs related to this are known as sunk cost. It is about exploiting the principal’s dependency and is known as a hold-up situation. (Lavrač et al 2007)

This might for example occur if the venture management team has developed a unique technique that is worthless if it is not fully developed. Then the venture capitalist might feel forced, to avoid lose all of their money, to let the project be completed even though they know that they have been deceived.

3.1.2 How information asymmetries can be dealt with

The two major ways to deal with problems related to principal-agent are to monitor or to give incentives (Andrén et al 2003). The overall idea of how to deal with moral hazard is to give incentives and thereby try to align the agent's interest with the principal's. Adverse selection is normally dealt with by trying to motivate parties to reveal relevant information. (Husted 2007) Sapieenza & Gupta (1994) have in their research found that a venture capitalist is to a greater extent managing their risk through involvement and monitoring rather than diversification, e.g. geographically or industrially**.** To avoid constant monitoring, sometimes a venture capitalist use governance mechanisms, such as contractual covenants. The relationship between the venture capitalist and the venture management team might be damaged if too many restrictions are imposed. If the venture management team feels for example that the governance in form of contractual covenants is getting too excessive the relationship with the venture capitalist might be damaged. This will in turn make the relationship between the management team and the venture capitalist less synergistic. It appears to be a trade-off between imposing contractual covenants and developing a synergistic and constructive relationship. A situation that can be unbeneficial for the venture capitalist is if the venture management team has worked for a relatively long time together, because then they will rely more heavily on their own intellectual resources rather than inputs from the venture capitalist. (Busenitz et al 1997)

There are indications that the information asymmetries might be less severe when the venture capitalists, have a very close informal relationship with the venture management team, and are more heavily involved in the venture's operational decisions. In these cases the venture capitalists have, due to their close collaboration, reached a stage where they see each other as business partners working for the same goals. (Lindström & Olofsson 2002) Similar conclusions have been drawn by Busenitz et al (2005). Their findings indicate that the information gap between a venture capitalist and a venture management team might be much smaller than the information gap that are supposed to exist between owners and managers in publicly traded companies. They mean that when the thorough due diligence process is over and the investment takes place, the information gap is in fact relatively small. (Busenitz et al 2005)

To better handle adverse selection some business angels rely on business associates. The business associate who suggests or introduces a certain venture management team's project, puts his own creditability behind and this makes the project more trustworthy for the business angel. Projects that are presented this way are more likely to be accepted than if the project was presented without any involvement from a business associate. (Riding et al 1995) To have business associates is synonymous with having a network and relevant theories regarding networks will be presented later on.

3.1.3 Critique against the principal-agent theory

The principal-agent theory has received a lot of criticism, e.g. for putting agents in a negative light (Husted 2007). Carr & Brower (2000) have been criticizing the traditional principal-agent theory because they mean that the behaviour between the principal and the agent are much more complicated than the theory implies. They also believe that the focus on self-interest as the only explanation for human behaviour in traditional principal-agent theory is incorrect. They have in their research discovered that professional pride, structural arrangements, friendship, antagonism, etc. have been influencing behaviour as well. (Carr & Brower 2000)

3.2 Network theory

Having a network is very important for venture capitalists. A network in turn, can be defined in many different ways. Porras et al (2004) define it in their research paper as

> *"a long-term relationship between organizations as actors that share resources to achieve negotiated actions for joint objectives"* (Porras et al 2004 p 354).

Usually a network is characterized as being complex because there are many people involved that are organizationally on different levels in the participating companies. Normally the structure is symmetric, meaning that the people in the network have come with equal contributions. The network is usually more of an informal kind, so legally binding contracts are normally not something that the parties are referring to. Since the relationships between the parties are normally well established, the network is usually fairly stable. This leads to continuity in the network. The processes that then take place in a network tend to be adaptive and collaborative. Usually a high level of routine has also emerged in the process. (Bengtsson & Nygaard 2001) A network can be arranged through contracts which make them more formal or through relations which tend to make them informal.

3.2.1 The network consisting of contracts

The overall idea in Transaction Cost Economics theory, TCE hereafter, is for the company to have a governance structure that minimizes transaction costs. To accomplish this, contract arrangements play an important role. The attributes of the transaction determine what type of governance structure it will be. There are three forms of governance structure; market, hierarchy or a hybrid. In market structure the company makes the transaction in the open market while the transaction will be in-house if the structure of hierarchy is chosen. (Chiles & McMackin 1996) An element that is important to evaluate is the level of uncertainty that the transaction holds. If it is a lot of uncertainty then a lot of resources must be spent to prevent the counterparty to be able to act opportunistic. The more uncertainty the more reason not to use the market but instead use an in-house solution. Other important factors in determining the governance structure are the frequency of the transaction and how specific a certain investment is. If a company makes a specific investment just to satisfy a certain customer, the investing company is facing a high risk, since the specific investment is impossible to use in transactions with other customers. The more specific an investment is the more resources must be spent on ensuring that the business relation will last. (Elg & Johansson 2000)

There are two underlying assumptions when it comes to TCE; bounded rationality and opportunistic behaviour (Elg & Johansson 2000). Bounded rationality implies that it is impossible to be objectively rational. Simon (1957) points out incompleteness of knowledge, difficulties of anticipation, and the scope of behaviour possibilities as proofs for bounded rationality. Incompleteness of knowledge deals with the fact that people only have a fragmentary knowledge about the future consequences of their actions and the conditions surrounding their decisions. Anticipated pleasure deals with the fact that the anticipated pleasure might be different from the realized pleasure from a decision. Finally the scope of behavioural pattern is inconceivable. For example a person normally has two legs, two arms, two eyes etc. and can therefore within just a minute do extremely many movements. It is however only very few of all these potential movements that come to mind when a person is confronted with different behaviour alternatives. There are therefore many potential movements that never reach the stage where they are valuated. (Simon 1957)

The assumption about opportunistic behaviour is controversial and means that there is always a risk that the counterparty might use the situation for its own advantage and even at the expense of others (Elg & Johansson 2000). Since people, according to this theory is bounded rational and opportunistic, contracts are frequently used (Porras et al 2004). These contracts contain different safeguards that try to protect each party from an opportunistic behaviour from the other. It is costly to negotiate, draft, and monitor contracts that have these safeguards. (Chiles & McMackin 1996) The bounded rationality assumption makes it impossible however to construct complete contracts (Williamson 1975).

3.2.2 The network consisting of relations

A network can, in contrast to the contract focused TCE, be built upon relations. The TCE theory has therefore received a lot of critique, and the critique from arguments related to embeddedness has been very influential. (Porras et al 2004) The embeddedness argument was put forward by Granovetter (1985). The basic idea is that trust is created by personal relations and not by institutional arrangements like contracts (Gronovetter 1985). Personal relation can give enormous trust but

> *"the more complete trust the greater the potential gain from malfeasance"* (Granovetter 1985 p 491).

Network of personal relations are found on every level within a firm but also towards customers, suppliers etc. Order and disorder, honesty and malfeasance are according to Granovetter (1985) something that can better be explained by personal relations and network of relations between and within firms, than with what the organizational arrangements look like. The state that different institutions are in is best understood by analysing their social structure. (Granovetter 1985) The level of embeddedness is setting both opportunities and constraints in a network. Uzzi (1996) found in his study over networking in the apparel industry that high levels of embeddedness gave several advantages such as risk-sharing and organizational learning. Relations that consist of low levels of embeddedness are relations that are kept at an arm's length. According to market theory, peoples' selfish and profit-seeking behaviour are reasons for having arm's length relationships. Uzzi (1996) however also concluded that the embeddedness increases economic effectiveness, but only up to a certain threshold where returns from embeddedness become negative. An optimal solution is therefore to combine the two. (Uzzi 1996)

Support for the embeddedness argument is presented by Husted (1994). The American companies he studied were often only making investments in transaction-specific assets after a certain level of trust had emerged between the parties. A company in his study did not go through with an investment that was very transaction-specific towards a certain customer because they did not feel that they could trust them enough. The counterparty therefore systematically tried to build up a trustful relation by for example inviting people from the other company over for picnics and ballgames etc. and eventually a relationship with mutual trust had developed. It was first then that the company made the transaction-specific investment. (Husted 1994) It is not only in Husted's (1994) study that trust within a network is emphasized. Trust is certainly an important part in the network theory and trust is more likely to emerge between individuals when there are no formal negotiations or agreements when the transaction takes place (Ulhøi 2006). Trust can also make transactions less uncertain and enable exchanges of goods and services that would have been hard to price or enforce contractually (Uzzi 1996). There are several conditions that can generate trust. It could be related to social norms which in turn can come in many different forms; reciprocity, norms of obligations and cooperation, norms of fairness etc. The trust generated can also stem from shared expectations among people, e.g. the same profession, ethnical background, or religious beliefs. Since honouring moral obligations are inherited in the social norms, it will constrain opportunistic behaviour. (Chiles & McMackin 1996) The high level of trust that transaction specific assets are associated with is based on social structure related to network and norms (Husted 1994).

A far more positive view than the TCE is that a network makes it possible for both parties to obtain strategic benefits that they could not have accomplished on their own. This involves a lot of trust since a close relationship, in order to reach strategic benefits, involves exchange of sensitive information etc. There is with this viewpoint no explicit assumption that people act in an opportunistic way. However, the risk of the counterparty to act in an opportunistic way is always present. It is therefore advisable to try to prevent this from happening. There are ways to try to mitigate the risk of this. If a company on several occasions clearly not acts in an opportunistic way this is a way of signalling that they take the relationship seriously. Other ways to mitigate this is if both parties openly explain and declare what strategic benefits they hope to achieve with their collaboration. (Elg & Johansson 2000) Naturally there are potential risks by being engaged in a network. Ojala and Hallikas (2006) investigated supplier networks in the electronic and metal industry, and pointed out lack of trust, inaccurate information sharing and asymmetry in power and dependency as the major threats. Things that they stated as ways to reduce the uncertainty in the collaboration were; trust, mutual dependence and open information sharing (Ojala & Hallikas 2006).

It is not only formal networks that affect economic outcomes but also social networks have an impact. Granovetter (2005) give three main reasons for why social networks have affect on economic outcomes. The first reason is that people think much information is subtle, nuance and difficult to verify so they rely more on people they know than impersonal sources. The second reason is because reward and punishment have a greater impact if it comes from someone that the person knows personally. Finally, trust is another reason because people tend to do the "right" thing despite incentives to act differently. (Granovetter 2005)

The density of a social network and how the ties are within it are factors that have great impact on what the social network looks like. A larger group is likely to result in lower density because there is a limit, e.g. cognitively and emotionally, on how many social ties that can be upheld. The free-rider problem is therefore more likely to occur in bigger groups where the density is lower. In a small very limited social network, e.g. a family, the free-rider problem is very unlikely to take place. Another very important factor in shaping a social network is if the tie is strong or weak between the persons involved in the network. Having a weak tie to a person is beneficial when it comes to get novel information. The tie is usually weak between a person and his distant acquaintance. It is more likely that novel information will be received from a distant acquaintance, since he is moving in different circles and thereby have access to different contacts and different information. A strong tie on the other hand, such as the tie between two close friends, is not that beneficial when it comes to receive novel information. The reason for this is that close friends are likely to move in the same circles and it is therefore likely that there will be a lot of information overlapping. (Granovetter 2005)

4. Empirical Framework

In this chapter we first make a short presentation of the respondents. The empirical findings are then presented. We present these by referring to our main topics during the interviews; investment process, network and principal-agent.

4.1 Presentation of the respondents

4.1.1 Malmöhus Invest

Malmöhus Invest was founded as early as 1979 and is thereby the oldest venture capital firm in Sweden. At present date, the firm is owned to 52 % by a consortium consisting of a group of business angels, Färs & Frosta Sparbank AB, and Sparbanksstiftelsen Färs & Frosta. The remaining 48 % is owned by Industrifonden. Malmöhus Invest solely invest in ventures located within Skåne and the Öresund region. The company's portfolio currently consists of nine ventures within the business areas of Life Science, Industrial Technology, IT and Telecom. The company contains a lot of experience and since 1979 it has invested approximately 350 MSEK in more than 90 different ventures. (www.mhusinvest.se)

We interviewed Håkan Nelson, Chief Executive Officer at Malmöhus Invest.

4.1.2 Teknoseed

Teknoseed is a venture capital firm located in the Ideon Science Park in Lund and was founded in 1997. They are focused on early stage financing and have since their inception made investments in 30 different ventures. Projects that Teknoseed invest in have ties with the academia and R&D community in southern Sweden. (www.teknoseed.se)

We interviewed Per Heander, Investment Manager at Teknoseed.

4.1.3 Connect Skåne

Connect Skåne aim is to provide an environment that is needed for a venture to be successful. It is a meeting place that try to bring technical, financial and other important resources together. They can help innovators with developing their business plan and help them to get in contact with investors. Connect Skåne is an organization based on voluntarily commitment from their members. (www.connectskane.se)

We interviewed Nicholas Jacobsson, contact person for Connect Skåne.

4.1.4 Business Angel Syd

Business Angel Syd is a network of business angels located in the south of Sweden. The network was initiated in year 2003 and its purpose is to facilitate the match between entrepreneurs and business angels. This is done by recruiting business angels, organizing investment forums, and conduct educational activities together with other business angel networks. The advantages with the network is that it provides a natural contact point for entrepreneurs, a tool for making marketing more efficient, a pool of competences, and an increased social interaction etc. (www.svca.se)

We interviewed Anders Hättmark, contact person for Business Angel Syd.

4.1.5 ALMI

ALMI is a governmental institution that has branch offices in all regions of Sweden. It provides loans to ventures but can also give loans to established small sized companies. They can also help these companies with business development. ALMI is not allowed to give loan to a company with more than 50 employees and are not allowed to be the main lender. The commercial banks must always be the biggest lenders in a deal. ALMI in Skåne has a lot of contact with both business angels and venture capital firms. (www.almi.se)

We interviewed Cecilia Elofsson, Investment Consultant at ALMI Skåne. The empirical findings from this interview are, due to its nature, not presented in this chapter, but are instead immediately integrated in the analysis.

4.2 Presentation of the empirical findings

4.2.1 Malmöhus Invest

The investment process

When it comes to creating a deal flow to Malmöhus Invest, Mr Nelson means that they have an advantage from having been a well established venture capital firm in the Öresund region for such a long time. Since they have been around in the region for such a long time, they have been able to build up a reputation that has made them a well known actor within this business area. To even further increase the deal flow to the firm Mr Nelson explains that they try to be involved in environments where projects are initiated, such as universities and research parks. It is also important to build up contacts with auditors, bankers, lawyers, and other people that tend to often get in contact with entrepreneurs. We usually do not go out and search for a specific project, but rather let projects come to us. This is made possible by, being present in the environments in which the entrepreneurs are operating and by doing so, building up an awareness of our firm's name, Mr Nelson says. He means that it is mainly through informal contacts that the firm's deal flow is generated.

When it comes to how Malmöhus Invest screens and evaluates different projects Mr Nelson says; "We do not invest in projects. We do not invest in companies. We invest in people." He stresses the importance of having an adequate management team in the venture invested in. Mr Nelson explains that the three main criteria looked at when they evaluate a venture are the people, the project, and the plan. The people, i.e. the venture management team, are the ones that shall realize the project. It is important that the project holds a certain status and a distinguishing character. Furthermore, there has to be a profound plan of how the project shall be realized, according to Mr Nelson.

Mr Nelson accentuates that Malmöhus Invest is not a financier, like banks and other passive lenders. Malmöhus Invest is a partner that actively gets involved within the projects invested in. This means that they will work closely together with the venture management team for quite some time. Mr Nelson means that it is therefore not only important with a competent venture management team, but also that there has to be a favourable personal chemistry between the different actors. He points out that it is important to have similar valuations and that the two parties easily can understand each other. There are examples of investments were the project has been very interesting and therefore invested in, even though there were flaws in the venture management team, and most of those investments have a very unpropitious outcome, according to Mr Nelson. He says that they also have examples of investments made, in which they relied heavily upon the venture management team but had doubts about the project, which got a very positive outcome. It is important to build up an informal relationship in order to be able to evaluate how the venture management team will be able to handle relations to suppliers, customers and employees etc. During this process the venture management team's strengths and weaknesses are also analysed, in order to find out which competences needed to be added to the project, Mr Nelson explains. The competences that need to be added to the project are found either within Malmöhus Invest, or otherwise it is brought in from external actors, that are to be found within the network, he says. The people within Malmöhus Invest are generalists and for some specific events specialists are needed to be brought in. We get help to "bring in pieces for the puzzle" from external actors but "we lay the puzzle and makes the decisions", Mr Nelson explains.

When trying to put a value on a project the starting point is what the project can be assumed to bring in at a trade sell, within a timeframe of approximately 5 to 7 years. With a needed expected annual return of approximately 30 % Mr Nelson explains that they calculate backwards to see how much they can invest in a project. Ultimately though, the valuation and the amount invested in a project, is reached through negotiations with the venture management team. Of course the venture management team is very optimistic at this stage and we are very pessimistic in our assumptions about the future, since we have to have margins in our calculations, he says. When negotiating about owner structure it is always a trade off between, getting a share of the company that is large enough, and keeping the venture management team motivated by letting them keep a significant share of the company. Therefore we never take over the majority ownership of a company, but instead approximately 20 – 40 %, Mr Nelson says. A way to solve the difficulties with combining capital need, valuation of the company, owner structure, and the venture management team's incentives and motivation, is to set up milestones. After the initial investment, further capital infusions are made in different stages of the project, and the level of dilution of the venture management's stock is determined by how well they have been able to reach the stated milestones, he explains.

There is always a high level of uncertainty in these kinds of projects and the risk is high. Mr Nelson points out that we can not eliminate the risk, but it is important for us to quantify it. The risks have to be pinpointed and brought to light, so that they can be managed.

Network

A great resource for Malmöhus Invest when it comes to building an extensive network, are the consortium of business angels that are owners of the venture capital firm, Mr Nelson explains. They all have profound experience from the industrial life and they all contribute to the firm with their personal networks. Another reason to why they have such an extensive network is that they have been in this business area and within this geographical location for such a long time, Mr Nelson explains. He also stresses how incredibly important it is to have an extensive network when being an actor within this business area. In order to manage and maintain the contacts in your network, you should regularly meet or get in touch with them. It is also a matter of give and take within a network, Mr Nelson means. If you give information to someone it is more likely that he also will keep you informed. Managing a network is facilitated by having a persona with high social competence, according to Mr Nelson.

The characteristics that Mr Nelson wants to emphasize as important when it comes to succeeding as a venture capital investor are curiosity, being a good listener, and having a solid interest for people. You also should have a fair amount of courage, persevering, and the ability to take action when it is really needed. He also believes that it is of uttermost importance to have an anchoring in the geographical vicinity, consisting of a profound and extensive network.

Principal-agent

Concerning information asymmetries, Mr Nelson means that the venture management team may have information advantage considering their profound understanding and insight in their own business and their product. On the other hand we also have an information advantage that comes out of our extensive experience from investing in ventures, he states. Mr Nelson says that he does not find the information asymmetries, in this matter, to be much of a problem. It is a lot about understanding and respecting each others different types of competence, he means. When assessing and trying to verify the information provided by the venture management team, you to a large extent have to rely upon your personal assessment of their trustworthiness, Mr Nelson reasons. Further he means that another way is to hire external experts that to some extent can verify the technology that is being developed. He wants to stress though, that the venture management team also has to rely upon what the venture capitalist firm claims that they can contribute to the venture with. It is a part of the process to build up a mutual trust between the investor and the venture management team, Mr Nelson says.

A venture management team can often be very optimistic when presenting their business, and therefore it really helps to have a lot of experience when assessing their statements, he explains. Having the experience of evaluating hundreds of ventures makes it easier to separate statements that are sheer over optimism from those that have a anchoring in real facts. Mr Nelson claims that you should sell your idea in an optimistic and positive manner, but if you oversell your business without having anchoring in reality, you will sooner or later be seen through and then your created bubble will burst. He means that it is all about giving a trustworthy impression. Mr Nelson can not recall of any case where they have been subject for fraud or deception without finding that out during the evaluation phase. However making misjudgements of facts that are at hand is impossible to totally avoid, he means.

After having made an investment there is only one way to stay updated of the projects development and that is to actively be a part of the project and to “live with the project”, Mr Nelson says. Being an active partner does not just mean that you have representatives in the board of directors, but rather having contact on an almost daily basis with the venture. We need to have the information almost instantly, rather than taking part of a report every quarter, he states. The access to quick information is made possible by having succeeded in building up an informal relation of trust between us and the venture. Mr Nelson means that it should be as natural for the venture management team to inform us about negative things as it is to inform us about positive things. This can of course be difficult to totally achieve in reality but it should be strived for, he argues.

Apart from building up the informal relation between us and the venture management team, we also make use of incentive programs in order to further secure that the venture management team strives for meeting our interests, Mr Nelson explains. In incentive programs, the goals stated and the criteria measured, has to be obviously manageable for the person it concerns. It has to be obvious that this person himself can affect the outcome of the incentive program, Mr Nelson explains. Therefore, incentive programs that are to general, e.g. result based bonuses, are inefficient, according to Mr Nelson. Another more formal way of having control, is of course the shareholder agreement contract. These kinds of contracts have to be at hand in those cases when the different parties can not come to an agreement in any other way, Mr Nelson says. Hopefully a contract like this does not have to come to use, but instead just put into the drawer after its signing. Though it is still of great importance, since you when formulating the contract emphasizes all the irregularities that can arise, and how they shall be treated if they do occur.

When investments have turned out unsuccessfully, the reason is normally shortcomings of the venture management team. It is very seldom that the product fails, Mr Nelson explains. In the end, it can then be said to be our fault, since we have not made a correct judgement of the venture management team. In order to be able to throughout the project have the best suited management team for the venture in its different stages, it is important to initially make clear for an innovator what his part of this project will be. Mr Nelson means that an innovator's competence might be of great importance in an early stage when product development is in focus, but in later stages there might be even more important to have skills of marketing and organisational work, in the top management. It is therefore often that the founder of a venture eventually will have to give up the position as Chief Executive Officer of the company, and that is something that can be problematic, due to the perceived loss of prestige in being demoted, Mr Nelson explains. The ventures that have the most successful outcome are the ones where the development of the project is a relay race, in which different sets of people with different sets of competences supplant each other, Mr Nelson says. To have the right set of competences, for the different stages of the venture, is our task to manage as a venture capital firm, he means.

4.2.2 Teknoseed

The investment process

Mr Heander mentions that they are in contact with research parks at different universities to get information about interesting project. It is however more common that entrepreneurs contact us directly and ask if they can present their project to us. We then look at how the market is for the presented project and what products are competing companies providing. Another important consideration is according to Mr Heander how many exits that have been made in the industry. It is also important to see that deals have been made. Mr Heander explains that they have a list that they go through and important considerations are who the people in the venture management team are and how unique their product is from a technical point of view. What really makes the difference are the people involved in the ventures. Mr Heander stresses the importance of finding people who can actually perform what they have said they will perform.

Sometimes we think the project that the innovator has is interesting but we want to follow the venture and maybe make an investment in a later stage, e.g. when the product is more developed, Mr Heander explains. It has happened that we have followed a company for a year or so before making an investment. Sometimes we are interested in investing but the capital need that the venture has is too big and we therefore explain to the venture management team that they need to find an additional investor.

An important part of the investment process is according to Mr Heander evaluations regarding patents. We always talk to someone who knows patents and they evaluate a certain product or technique from their perspective, Mr Heander explains. Usually we also talk to someone who has knowledge about the technology. Mr Heander says that they also talk to someone who knows the market for the product or technology. So usually there are three people involved to help evaluate the technology or the product. Our competence is in our general business knowledge and our ability to provide competence to the ventures.

The due-diligence is something Mr Heander refers to as being a very important part of the investment process. Early in the due-diligence process we have discussions about what the venture management team thinks their company is worth. This discussion is important since we do not want to spend too much time on something that can never be realized due to the value that the venture management team has put on their venture. A lot of the projects presented to us are new technologies which make it hard to predict how big the market might be for the product. It is important that the venture has a unique technique. Usually the venture is a business to business company. Mr Heander explains that Teknoseed has not made any investments in companies that are targeting consumers. It is important that the technology that the venture has can be protected, usually with patent. If there is no possibility of patent then it is very important to be sure that the managers have unique skills and that the product is difficult to produce elsewhere.

A dream case is, according to Mr Heander, when the entrepreneur has a lot of experience of running and starting businesses and has good relations to important customers. It is however unlikely with such cases. One important thing in the investment process is that the venture management team needs to have an understanding that there is a need for different roles in different stages. An important part of our work is to hire the right management at the right time depending at what stage the venture is in. The venture management team needs to be aware of this and accept that sometimes management changes are necessary. Mr Heander believes it is important to recruit managers externally because it is not good if the venture is completely represented by it financers.

Mr Heander stresses the importance of exit possibilities. This is a crucial part of the investment process. When we make an investment the most likely scenario for exiting a venture is by a trade sale 3-7 years after the initial investment Mr Heander explains. Before we invest in a certain venture we always check to see how many trade sales and other transactions have been made in the area that the venture is operating in. Many industries are conservative and are only interested in buying companies that have a profit, but to build up companies to be profitable usually takes longer than seven years.

It is hard to state a certain required rate of return in terms of a specific figure. If we for example make investments in ten different ventures we anticipate that five will file for bankruptcy, three will be sold and we will get our invested money back and two will be very successful. Mr Heander explains that they do not use any traditional valuation models but instead make estimated values. The team has had ten years of experience which gives them good ideas about what the venture’s value is. What determines the value is for example how big the market is for the venture’s product. Another example that Mr Heander gives is how many actors there are in the specific market. If a market consists of a few dominating companies that historically have been acquiring smaller competitors, then this is an interesting market. An industry that Teknoseed finds interesting is the life science. It is a business that has good growth rates and there are a few major companies that buy competitors with interesting patents before they have put any drugs on the market. They buy them before they have launched their drugs commercially, Mr Heander explains.

When it comes to ownership, which is an important part of the investment process, Mr Heander declares that they never want to own 50 % or more of a company. Usually our ownership is between 10-20 % However in some ventures the venture capital investors part might, put together, exceed 50 %. If Teknoseed are getting close to 50 % it is because the venture has performed poorly. Usually we know that future financing will be done by a bigger player and we are prepared that our ownership will be reduced and therefore it is vital to have created as much value as possible before the dilution, Mr Heander explains. Teknoseed usually set up milestones that they expect the entrepreneur to fulfil and it is challenging to set these milestones. Additional investments from Teknoseed normally require that these milestones have been passed. They do not use the arrangement where the venture capital firm for example buy 80 % of the company and then give back shares to the entrepreneur if the venture is performing well. Mr Heander explains that this is a system that is not established in Sweden.

Network

We use our network when we evaluate a certain product or technique. Mr Heander says that Teknoseed has persons that can be contacted for issues related to patents, technology and markets. It is also important for us to have contacts at different universities. They can help us to verify a certain technique and can help us to get in contact with interesting projects.

Since the venture management team has a information advantage about their product or technology we verify a certain product or technology by contacting someone from a university that we collaborate with. It is also possible to consult with someone here at the research park. Sometimes the information is very sensitive e.g. a certain faculty at a university has come up with a new technique and they are therefore the only one who knows about that and then we will visit them, Mr Heander explains. We also have people in Denmark that we collaborate with and that we can contact. Mr Heander also declares that Teknoseed has people in their board that they also can discuss with. He emphasizes the benefits of having an extensive network with different type of contacts.

Principal-agent

One way for us to handle principal-agent related issues is to stipulate a contract with the venture management team that limit their possibilities to do certain things, e.g. they can not without the permission from Teknoseed change the president of the company. When we make an investment the venture management team has to guarantee certain things, e.g. that all innovations that they come up with belong to the venture. The negotiations around these things are according to Mr Heander a good indication of how the venture management team will be to work with.

Mr Heander also states that they usually have a very close relationship with the company to mitigate problems related to the agent. The longer away geographically the venture is the harder it gets. Some of the ventures that Teknoseed invests in, are located in the same building as we are, which enable us to have daily contact with the venture management teams, Mr Heander explains. Others are located very close geographically and we visit them at least once a week. In the ventures that we have invested in, that are not geographically close to us, it is important to have someone in the board or make sure that not only the president has all the knowledge about the product and the technique.

In addition Mr Heander explains that they receive monthly reports from the ventures that they have invested in and they attend board meetings 4-6 times per year. If we are not member of the board we are adjoined. The monthly reports are ways to see how the company is progressing and how close they are to meet their milestones. Market activities and applications for new patents are other things that might be included in the monthly reports. Mr Heander thinks the fact that they have such as close relationship with the companies is probably the explanation why so few of the ventures we have invested in have filed for bankruptcy.

Problems are often more related to the venture management team than to the product or the technique. A worst case scenario is when the biggest owner of the company is the venture management team and all the knowledge is accumulated by this team. Mr Heander points out that an important part for them is to early ask the venture management team if they are willing to be complemented. For example that the innovator is focused on product development and no longer is part of running other operations such as marketing. To do this is very challenging and especially if values are started to be created in the venture because then the innovator might feel that he or she is losing control.

4.2.3 Connect Skåne

The investment process

A business angel in a business angel network is regularly introduced to various projects that need financing. If an angel finds a certain project interesting a meeting is usually arranged where a discussion takes place. Mr Jacobsson points out that the time from when an angel is introduced to a project to when the investment take place can differ a lot. If it is a straight forward case the investment from the business angel can take place already during the second meeting. He also knows of cases were the angel has waited so long that the venture is no longer functioning properly. In those cases the angel has followed the firm closely but for some reason or parameter decided not to invest. Then when the firm is facing bankruptcy or similar the angel might find the situation different and decide to invest, Mr Jacobsson explains.

There are differences between how business angels and venture capital firms conduct their investment process, according to Mr Jacobsson. He is certain that an angel acts faster than a venture capital firm when it comes to making an investment decision. Mr Jacobsson also says that he believes that business angels are more relying on gut-feeling. He points out that a venture capital firm always has a responsibility towards someone, while a business angel is only responsible towards himself. This makes it possible for them to put more emphasis on gut-feeling according to Mr Jacobsson.

Mr Jacobsson says that business angels normally have an extensive background in a certain business area and that they therefore are more willing to invest in that area, while venture capital firms usually do not have such specific knowledge and have to rely on external experts to get relevant information. There is however situations where an angel makes an investment in an area where he lacks own experience but he does the investment together with another business angel that knows the business very well, Mr Jacobsson explains. If the business angel does not have the knowledge he will according to Mr Jacobsson probably use his personal network in order to verify if the project is promising or not. If a business angel do invest in a project in which he has limited own knowledge, he certainly has a very strong confidence in the entrepreneur and fully believes that this person knows what he or she is doing, Mr Jacobsson means.

When it comes to evaluating the ventures Mr Jacobsson says that this is something that differs from business angel to business angel. Mr Jacobsson points out that gut-feeling is a big part of their decision to invest. He also points out that the business angels usually also evaluate if the product is technically feasible and has potential to be accepted by the market. They use their network to gather information and their own experience to evaluate a certain project, Mr Jacobsson explains. It is not common that they hire a consultant to make an analysis. There is seldom a structured form of how the investment evaluation process is conducted, according to Mr Jacobsson but one important part of this is the meeting with the entrepreneur since it is very important that the business angel has full confidence in this person.

Business angels normally do not want a product to have a long way to be fully developed. They can accept some time for product development, maybe 1-3 years, but they want it to be nearly fully developed and ready for the market when they invest, according to Mr Jacobsson. He also asserts that business angels often prefer if the exit can occur around 3-5 years after the initial investment. Mr Jacobsson also emphasizes that it is very important that the entrepreneur is social and fit well with the business angel.

It does not have to be some new technology for the business angels to be interested. They are also interested in companies that provide different services. They can for example invest in a company that will set up carwash machines, Mr Jacobsson explains. Projects are on many occasions not based upon a patent. Projects with patent have good chances of being accepted by venture capital firms, which often have patent as a necessary condition for an investment. Business angels can according to Mr Jacobsson be involved in projects without patents to a far more extent than a venture capital firm.

Mr Jacobsson means that it is normally difficult to predict cash flow streams in early ventures, and it is therefore hard to make a discounted cash flow analysis. In some cases, usually bigger projects where the market is known and it is possible to estimate the market share, then a cash flow analysis can be conducted but it is still very hard to predict the cash flows. Normally the gut-feeling is important, but also experience, when the business angels are evaluating a certain venture's value. A company that does not have any sales usually gets a value around 3 to 10 million SEK. If a company has a very developed product with patents, and there is a big potential for their product, the value can reach 10 to 20 million SEK, according to Mr Jacobsson. Further, he says, that he usually deals with companies that are valued around 5-8 million SEK and he explained that he does not present projects to the angels that are valued above 20 million SEK. It is common that the business angels in the initial investment get 10 to 30 percent ownership in the venture.

Network

The network is used for finding out the risks and the potential with a certain project. Sometimes business angels can invest in an area where they do not have any knowledge but they have someone in their network that has and therefore they are able to make the investment together. The network can also be used to get ideas for new interesting projects.

There are many risks when investing in ventures and this is considered in the investment process. The business angels try according to Mr Jacobsson to talk to people in their network that have knowledge about the risks in a particular project. For example if a business angel is considering investing in a company that has developed a product for the dairy industry he can call a person in his network that has a background in the dairy industry. He can then tell the business angel what he thinks about the new product and he might also suggest a person that he recommends the business angel to contact to get even more information about the product. This is the way that they minimize their risks; they do their own type of due-diligence. Since business angels normally decide pretty early if they want to invest and rely a lot on gut-feeling, they sometimes miss things that could have been identified in a more thoroughly due-diligence process, Mr Jacobsson explains. On the other hand the fact that they use their gut feeling makes it possible for them to get involved in investments, that venture capital firms can not, and get very high returns.

Principal-agent

One crucial thing when it comes to principal-agent problems is according to Mr Jacobsson to be able to make a judgement about the venture management team. Is he telling the truth, does he have any reason to lie, are examples of things to consider, Mr Jacobsson explains. It is hard to make the venture management team accountable after the investment unless there have been direct lies. Mr Jacobsson points out that the business angel put an effort in trying to get to know the entrepreneur. The relationship after an investment has taken place is usually beneficial for both parties, since they are working towards the same goal.

Another area related to the agent is that the venture management team has an information advantage about their product and to verify new technology is challenging. The business angels try to use their network to get help with verifications. They also try getting as much information as possible from the entrepreneur, Mr Jacobsson explains.

The business angels are also usually very active board members in the ventures that they invest in. Some business angels are according to Mr Jacobsson taking on even more active roles in the venture.

A situation where an entrepreneur realise that his product will probably fail but decides not to tell this to the business angel, since he has put so much prestige and effort into the project, is something Mr Jacobsson has not experienced. He thinks this is because it is hard to keep this type of information away from the business angel, since he usually is a very active board member and follows the company closely. The board members should follow the product development very carefully. If the entrepreneur faces trouble in the product development it is likely that he or she will tell the business angel in order to secure more money to enable the necessary remaining developing work.

Sometimes business angels work out milestones that the venture management team must fulfil, e.g. invest 2 million SEK and when a certain milestone is passed an additional 2 million SEK will be invested in the venture by the business angel and during this time the entrepreneur is prohibited to discuss financing with an external party. However, according to Mr Jacobsson the business angels' initial investments are usually the sole investment. Mr Jacobsson considers it to be wise to invest on two different occasions and that the second investment is only made if a certain milestone has been passed. He means that this gives an opportunity to find out if there is information that the entrepreneur has hidden from him since there will be some time between the initial investment and the second investment.

4.2.4 Business Angel Syd

The investment process

Mr Hättmark explains that the first contact is almost always initiated by the venture management team. Furthermore he means that after contact has been initiated, the business angel spends some time evaluating the entrepreneur, the business plan, and his own potential to contribute to the project. The business angel usually gets in contact with his auditor, banker and possibly a few more people before taking the decision to invest. Mr Hättmark wants to stress that there are no well recognized and generally used models for how the business angels act when making an investment in a venture. He means that even though there is some level of systematic behaviour when business angels evaluate investments, it boils down to intuition and gut-feeling. The most important factor when a business angel evaluates a project is the venture management team, and what the persons are like, Mr Hättmark says. When it comes to this relationship it has got to feel right, he means. The process of evaluating persons differs a lot from business angel to business angel. Mr Hättmark means that all people got different ways of evaluating a person, and that there are hundreds of different ways. A business angel basically invests in people, more than anything else. According to Mr Hättmark, a very successful business angel said "I don't care much about gut-feeling. I must love the entrepreneur". The importance of the venture management team cannot be emphasized enough, according to Mr Hättmark. He means that if the persons in the venture management team are charismatic, competent, and got the drive that is needed, than almost anything can be sold.

A part from the venture management team, the business plan is also very important for a business angel when evaluating a project, Mr Hättmark explains. That the product must hold a certain status and distinguishing character, is not necessary, but it is perceived to be a great advantage if there is a patent for the product. What is more important is that there is an expected market, for the product, that has high potential. When it comes to exiting an investment, a business angel usually wants to see a possible way to do an exit within 3 to 5 years, according to Mr Hättmark. Business angels also try to invest in ventures that operate in business areas, in which he or she has got a lot of experience and competence. This is due to the business angel's network, which probably is best suited for the business area that the business angel earlier has been active in. The business area factor is of much more importance than the factor of geographical vicinity, when a business angel chooses a project to invest in, Mr Hättmark says. When it comes to putting a value on the venture, in order to come to an ownership agreement, Mr Hättmark means that it is difficult to reach a solution that is fair for both parties. When trying to make a valuation you rather look at the substance within the company, e.g. a patent, than future cash flows, he means. There are few strict economic models that work efficiently in these early stages. The proceeding is more about determining the future capital need, in order to see how much capital the business angel should invest, Mr Hättmark explains. Then you look at what share of the company you as an investor can make claim for. Mr Hättmark says that a wise business angel never makes claim for the majority of the shares, because then there is a risk that you take away the incentives and the motivation from the venture management team.

Network

There is a lot of uncertainty that surrounds an investment in a venture. What the business angels usually do, in order to try to reduce uncertainty, is to carefully look through the business plan, and often to consult suitable people that they can find in their network, according to Mr Hättmark.

Since you can have a lot of commercial advantages from having an extensive network it is important to spend time on networking. Mr Hättmark says that the business angels that have succeeded the best with building their network are the ones that realize that they have to invest a lot of time in their network. According to Mr Hättmark it is important to understand that it takes patience to build up a network. Further he explains that for a business angel to be a successful network builder, he needs to have a general social competence, and maybe most important of all, a drive and the ability to make things happen. Those business angels that really have succeeded in building their network are those that have been very systematic, have made documentations, and actively work to have clearness over their contacts, according to Mr Hättmark. The purpose of the networks is to give supplementary competence to each other within the network. It is very important that there is a structure and rules for how the relations in the network shall function, in order to prevent the network from falling a part. It is also common that the network is being used for sharing risk. Often a couple of business angels go together for making an investment, Mr Hättmark says.

Principal-agent

Mr Hättmark means that the venture management team often is very optimistic when presenting their project. The assumptions made are often very unrealistic with growth rates that almost never have been seen before. Mr Hättmark explains that when the assumptions made by the venture management team, are not anchored in facts, then the business angel will most likely discard the whole project. Even though the assumptions can be revised, the tendencies of the venture management team to lack judgement can be enough for a business angel to choose another project. Mr Hättmark can recall cases in which the assumptions in themselves, in the end have led to the failure of the entire venture.

It is common that a business angel develops a relationship with the venture management team that can be characterised as more of a friendship than a formal relation. Mr Hättmark means that the business angel tends to get very emotionally attached to the project and the venture management team, and the point is that the venture management team should get as much access as possible to the network of the business angel. Usually the business angel works on an operational level in the company, and it is also common that the business angel is a member of the board of directors.

There is according to Mr Hättmark always a risk that the venture management team is unwilling to abandon an unsuccessful project. It is also common that they underestimate the time and resources needed, before the project can finance itself. He also reasons, that the venture management team can be unwilling and reluctant to provide the business angel with some information. This is something that is very difficult to handle, according to Mr Hättmark. He means that it is mostly about intuition and reliance upon the venture management team. The business angel has to find the venture management team trustworthy during the initial phases, and after the investment is made he or she has to be able to trust them, Mr Hättmark explains. Overall Mr Hättmark means, that the complexity revolving the relationship between the business angel and the venture management team is most likely difficult to capture with a model.

Since a business angel does not have the same resources as a venture capital firm, it is impossible to reach the same level of rationality and thoroughness, when handling the investment. Therefore the business angel has to rely upon their gut-feeling to a much larger extent, according to Mr Hättmark. He also means that the relationship between the business angel and the venture management team tends to be more of the informal kind, while a venture capital firm has a more formal relationship to their venture management team. A venture capital firm might plan to exchange the management in the venture to other people with, for the coming challenges, more suitable competences. Mr Hättmark says that this is not as usual when it comes to business angels.

The most successful business angels are those that have energy, are very involved in the projects and can put a lot effort into them. Mr Hättmark can also recall several examples of ventures that have become very successful mainly because of the business angel having very useful contacts within his network.

5. Analysis

In this chapter we interpret and analyze our empirical findings by using our theoretical framework. We discuss what we find to be possible ways of reducing the information asymmetries between the venture capitalist and the venture management team.

5.1 Verifying the product

The venture management team has an information advantage about their product and for a venture capitalist to verify a new technology can be challenging, according to Mr Jacobsson. It is crucial for a venture capital firm and for a business angel to be able to have someone that can verify a certain product or technique. The reason for this is that the venture management team has an information advantage, and can be biased in the way they give information. Husted (2007) means that informed people often try to take advantage over uninformed people. In addition, a venture management team normally has incentives to overstate the advantages of their product. Mr Hättmark means that the venture management team often is very optimistic and often also unrealistic when presenting their products. This leads to the problem of hidden information, which makes it hard for the venture capitalist to correctly asses the venture (Amit et al 1998).

Mr Nelson means that information asymmetries regarding the product can be handled by making use of external competence. Mr Heander says that they always make use of experts within their network when it comes to evaluating a certain product or technique, in order to understand it better. Also Mr Jacobsson means that, even if a business angel usually does not have the same resources as a venture capital firm, he will when lacking knowledge on his own, normally use his personal network in order to verify if the project is promising or not. A person, within the business angel’s personal network, that has a lot of experience within a certain business area can give his expert opinion on a product in this particular business area and he might also be able to suggest other persons that can further help the business angel to verify the product, according to Mr Jacobsson.

Since the outcome of a venture is to a great extent determined by the product or the technique, it is of utter importance that someone really knows how to do a proper verification of the product. A thoroughly conducted verification will reduce the information gap between the venture capitalist and the venture management team. It will make them more equal and it will make it possible for the venture capitalist to make a sounder and better investment decision. To be able to find someone that will do this verification it is essential to have an extensive network. Mr Hättmark means that the purpose of a network is to give supplementary competence to each other within the network and Mr Heander explicitly states that they use their network in order to find the suitable competence to help verifying a product. Mr Heander also explains that they have a diversified network where different actors can help with different verification areas, such as patent, product and market. Since a venture capital firm or a business angel can be faced with so many different types of products or techniques, we find it vital to have an extensive network that will cover a lot of different industries and business areas. Having an extensive network with people competent of conducting product or technique verifications therefore seems to be an important tool for revealing hidden information and thereby reducing information asymmetries.

Mrs Elofsson agrees with this argumentation. Her experience is that when the investors own knowledge and experience is not enough, they make use of their network in order to attain the competence needed to verify the commercial potential of the product. The organisation Mrs Elofsson work for, ALMI Företagspartner, also has a network that they can consult when in need of certain competences for certain tasks, such as product verifications.

5.2 Have the right competence in the venture management team

An important task for the venture capitalist is to make suitable changes in the venture management team, in order to have the right competences in the venture, but also to get better insight into the venture. When one party has no insight and is unable to observe relevant actions that are taken by the other party, there is a problem called hidden action. (Amit et al 1998) Mr Heander pointed out that a nightmare scenario is when the venture management team holds practically all information. Mr Hättmark reasons that the venture management team can be reluctant to provide the investor with some information. In a situation like that, one party has a lot of relevant information that is unknown for the other party, resulting in hidden information. (Amit et al 1998) We believe that hidden information and hidden action are common problems initially, since the venture management team normally is the founders of the company and that they therefore have extensive insight and great knowledge about the venture. They not only know the product, but all other things related to the company like information about suppliers, customers, strategies etc. All this knowledge gives the venture management team an information advantage resulting in information asymmetries between them and the venture capitalist. To have this overall role and handling all functions within the company is natural in the beginning when the only person working for the company usually is the founder or founders of the venture.

According to Andrén et al (2003), there are two major ways of how to deal with problems related to information asymmetries; monitoring and giving incentives. When the venture capitalists use people from their own network in order to supplement the venture management team, it is a way of monitoring the venture, since the venture capitalist gets better insight into the venture by doing this. Mr Heander explains that they usually try to have a close relationship to the venture management team and to always have members in the board of directors, in order to mitigate problems related to information asymmetries. As soon as a venture capitalist steps in, changes should be made in the venture management team in order to reduce the information asymmetries. The venture capitalist gets vulnerable if the venture management team keeps control over all parts of the business. When the venture capitalists have persons from their own network as part of the venture management team, they get better access to information and can more efficiently monitor the actions that are taken within the venture. In this way the problems with hidden information and hidden action can be reduced.

We have discovered that another reason for changing the composition of the venture management team is that the venture goes through different stages and need different competences at various stages. Mr Nelson means that to have the right set of competences for the different stages of the venture, is their task to manage as a venture capital firm. It can be challenging for the investor to find the right people at the right time. To be able to accomplish this, we think it is vital to have an extensive network of skilful people. Mr Nelson means that the competences that are needed for a venture invested in are either found within their company or brought in from actors that are to be found within their network. Business angels though, are usually involved so early in a venture that the time for management changes has not yet come. Furthermore, a business angel usually does not have enough resources to supplement the existing venture management team with new people. It is often just a matter of what the business angel can contribute with, by their own work that will decrease the information asymmetries. However, business angels often manage to reduce the information asymmetries by having a close informal relationship with the venture management team, since this leads to a state where they see each other as business partners working for the same goals to a larger extent (Lindström & Olofsson 2002).

Mrs Elofsson explains that it is very common that a business angel take on a very active role in a venture newly invested in, and that the business angel often takes a seat in the board of directors. Usually the business angels do not have as much resources as venture capital firms. If, however, there are enough resources, the business angel often tries to find the right competences within his network in order to supplement the venture management team with the knowledge and experience needed in the venture at the time, according to Mrs Elofsson.

5.3 Make investments together with other venture capitalists

Sometimes an investment is too big for an individual venture capital firm or a business angel to bear and they need someone to help them in the financing of a certain venture. Sometimes the venture capitalists find projects to be very interesting, but want to invest only if the venture management team can find an additional investor. Mr Heander means that they have been interesting in investing but the capital need for the venture has been too big and an additional investor is therefore required for the investment to take place. It is in our opinion reasonable to believe that if the business angel or the venture capital firm thinks that a project is very interesting, they contact another business angel or venture capital firm to secure the investment themselves. This is why it is so important for a venture capitalist to have access to a network.

We firmly believe that a powerful tool to reduce information asymmetries is for a business angel or a venture capital firm to make an investment together with another venture capitalist. This results in the venture being examined by two professional investors. There are several imaginable strategies depending on the situation and the strengths of the different investors. One strategy that could be efficient is if both investors are conducting their evaluation separately. The venture management team will then be faced with two different investors and will have to present their product, answer questions etc. to two different actors on different occasions. The two investors can then meet and present to each other what they think about the project. What parts of the venture they think are good, what parts they consider being less attractive, and what is their opinion about the person or persons behind the project etc. They can then compare what they agree and what they disagree about. The venture has been examined from two different angles and it is likely that they when they compare the information have more knowledge than they could ever have gathered individually.

What we think is most beneficial with this strategy is that eventual inconsistencies will be brought to light. In inconstancies lies great risk. The venture management team might put focus on the things that they believe to be the most appealing for the venture capitalist. For example Mr Hättmark mentions that assumptions made about the growth rates can be very optimistic and sometimes even unrealistic. We think it is plausible that they will change focus depending on the preferences of the investor. If for example the venture capital firm is known for appreciating products that are advanced in a technical sense, the innovator will probably put a lot effort to highlight the technical part of the product, but if the venture capitalist is known to be more interested in the set of competences within the venture management team the innovator will probably put focus on highlighting that part. Our point is that if the innovator put focus on a certain area for each investor they will in their comparison probably detect if there are any inconsistencies. Another advantage with this strategy is that since both will use their own network when it comes to for example verifying the product, there will be a lot of people involved. It is therefore more likely that if there are deficiencies, these will be identified. The main point is that it is likely that hidden information will be revealed, ultimately leading to fewer unprofitable investments.

There are however some drawbacks with this strategy. It will take longer time because both parties need to do their own evaluation and then they must meet and have discussions whether to invest or not. This is a risk since, an investment can be urgent, and there might not be time for a lengthy evaluation process. In addition the venture management team might instead find another venture capitalist that has a more rapid evaluation process. Since there are two investors that individually will face the venture management team and draw upon their attention, the venture management team will have less time to focus on the core business and this might harm the venture. For the venture capitalist to have, besides from the venture management team, an additional owner could be troublesome when it comes to making strategic decisions. Mrs Elofsson confirms the disadvantage with having co-investors, since problem can arise from having a wider ownership base. It is therefore of great importance to really talk these issues through before investing. If this is not done we believe the consequences could be devastating for the company because it might not be possible to have a uniform strategy. However, we think it seems fairly logical that two professional venture capital investors are likely to have similar opinion when it comes to how a company should be run. Even if the strategy with separate evaluations take more time and resources in the beginning, it still is our belief that if this can prevent a venture capital firm or a business angel from making one single investment in a venture that later files for bankruptcy, it is definitely worth it.

Another possible strategy to reduce information asymmetries is if the two venture capitalists decide to be responsible for different parts of the evaluation process. If for example one of the investors has a network with people who are extremely good at assessing patents and other legal issues then this investor is responsible for that part. The other investor might have a strong network when it comes to people who know a certain market very well. By collaborating, these two investors will reap the benefits of each others networks. It will be beneficial for both parties because they will be benefited from networks that they could not reach themselves. The drawbacks are similar to the strategy with conducting separate evaluations, but an advantage is that the investment process can go faster because the investors are doing parallel evaluations on certain limited areas. A disadvantage is that the investors must rely heavily on the other party and it is a risk that the other party misses something that could have been detected if the investor had made the entire evaluation themselves. We think that in order to be engaged in this type of strategy it is vital that both parties really know each other and rely completely on each other. A way to generate trust is by continuously not act in an opportunistic way and thereby signalling loyalty (Elg & Johansson 2000). To generate this high level of trust focus should preferably be on relations instead of contracts (Porras 2004). It must be a high level of embeddedness within the network in order to get the parties to entrust each other to this extent and personal relations can give enormous trust (Granovetter 1985). We find it suitable for a venture capitalist to spend time building up a relation with another distinguished venture capitalist. Another benefit by making an investment together with another venture capitalist is that two investors will be active in the venture's operations. This gives them the possibility to conduct efficient monitoring and thereby get better insight into the venture, resulting in reduced risk for hidden actions. The bottom line is that the venture management team has an information advantage, resulting in information asymmetries, and we believe that collaboration between two venture capital investors would be a fruitful way to reduce these information asymmetries, due to the evaluation of the venture from two different perspectives.

Mrs Elofsson agreed in general with our argumentations but she did not have enough experience, of how information asymmetries are affected by co-investments, to be able to fully confirm our conclusion that using ones network for making co-investments is a strategy to reduce information asymmetries.

5.4 Build your network efficiently

Mr. Hättmark, explained that people who have benefited the most from their networking are the ones who have worked very systematically with it. He therefore emphasizes the importance of having a systematic structure when it comes to networking. It takes, according to Mr Hättmark, a lot of time to build up a network so having patience is important. By being systematic we think it is possible to have a good overview over the network and thereby make it easier to map out which persons is a part of the network and what their contributions are. It is crucial to be able to cover more and more business areas and functions related to the business, e.g. legal issues. The more areas that can be covered the more likely it is that the information asymmetries can be reduced, e.g. since more arguments and assertions from the venture management team can be examined by people in the network. By having a clear picture of what each person can contribute with, it should also be apparent what type of information that is lacking. For example, a venture capitalist might discover that he lacks someone to consult to when it comes to investments in alternative, more environmental friendly, energy sources. The venture capitalist can then try to, by using his network, come in contact with someone who has knowledge about energy sources that are environmentally friendly. Part of being systematic is maintaining the network in an efficient way. It is vital to uphold contact with people that are important. Mr Nelson from Malmöhus Invest stressed the importance to meet people from the network on a regularly basis to ensure that the right contacts are upheld.

We assert that one of the more important ways of how to build and to maintain a network is to always have novel information to exchange with people in the network. Granovetter (2005) shows that to get novel information it is important to have acquaintances. The ties with these are normally weak. It is likely that these people are a bit different and move in different circles (Granovetter 2005). So to be able to exchange information more efficiently, and thereby being able to expand and maintain a network, we believe it is vital to have access to information that is novel and that is why it is so important to have weak tied acquaintances. Both Mr Hättmark and Mr Nelson explained that an important factor for being successful in networking is being socially competent. We believe that this is an advantage for being able to efficiently find new acquaintances. This requires much more social skills than to get to know someone who is very similar to oneself and moves in the same circles. It is therefore our belief that being socially competent is vital in order to maintain and expand a network. Expanding a network is likely to result in a snowball effect, meaning that the new established contacts can lead to additional contacts. A crucial part is then to determine which contacts are important and which ones can be disregarded since there is a limit on how big one's network can be. To be able to make those calls we believe experience is a crucial factor.

Besides working systematically and to have social skills we think it is important to have an open mind and actively seek out new persons that might be interesting. Mrs Elofsson confirms this belief and also adds that it is important to be active in informal everyday situations, e.g. talking to other parents at the day care centre.

Having social skills is, as we stated earlier, important in networking. However, this is something that has not sufficiently been dealt with in the theories we have been using. To capture and to understand this, theories from psychology or sociology are more appropriate.

We think however that some of the social skills can not be taught, it is a more of gift that you either have or don’t have. This puts a limit on how efficient someone can build and maintain a network.

6. Concluding comments

The purpose of our study was to increase the understanding of how venture capitalists can use their network in order to reduce information asymmetries between themselves and the venture management team. Here we present the conclusions of our study. During this study we have also come aware of other ways to approach this field. We therefore give suggestions for further research that we find needs to be done within this field.

6.1 Our conclusions

For the venture capitalist to be able to fully understand the product or technology that is often vital for the projects invested in, he needs to have the competence to verify the technology within his network. It is essential to have a diversified network that covers many different competences, in order to increase the chances of being able to verify a certain technology in a successful way. A verification of the technology gives the venture capitalist a more profound understanding of the venture's product, which results in the revealing of hidden information, thus reducing the information asymmetries.

By complementing the venture management team with competence from their own network, the venture capitalists can get better insight into the venture. By obtaining control over key positions in the venture the venture capitalist get access to important information that is crucial for the further development of the venture. By not letting the venture management team alone hold all the information crucial for the ventures further development, the venture capitalist can reduce the information asymmetries primarily in form of reduced risk for hidden actions. Being able to complement the competence already existing within the venture management team is being facilitated by having many skilful persons with different competences within the network.

For a venture capitalist, it would be beneficial to arrange investments in ventures in cooperation with other venture capitalists. By doing so, the two venture capitalists can draw advantages from getting access to each others strengths, competences and contacts, and in that way instantly increase the network at hand. Furthermore, the due diligence process will be conducted more efficiently when two different investors evaluate the venture from their different perspectives. This leads to the revealing of hidden information, resulting in reduced information asymmetries. We therefore conclude that it is of great importance that venture capitalists cooperate.

In order to successfully implement the strategies mentioned above, it is crucial to have an extensive network. To facilitate the use of the strategies mentioned above a venture capitalist should therefore be very structured when developing his network. The venture capitalist should make documentations over the contacts within the network, map out key competences and also the competences that are missing within the network. By doing this the network can be complemented with useful competences and used in a more efficient way.

6.2 Suggestions for further research

We had principal-agent theory and network theory as our theoretical framework, but we have throughout this study realized that this kind of information asymmetries is nothing these theories can fully help to explain. Our conclusion is that a lot of this boils down to being a good judge of character. It is therefore clear to us that an additional dimension is necessary to get a more gradate picture of how venture capitalists can handle the information asymmetries between themselves and the venture management team.

Since the persons we have interviewed put such a focus on personal skills and social competence, we are convinced that more research should be spent on evaluating this complex field by also applying psychological and sociological theories. We realized that common theories in business administration and economics such as principal-agent theory and network theory do not fully capture the complexity surrounding the relationship between the venture capitalist and the venture management team. It would be beneficial for venture capitalists, especially for one that has no previous experience in investing in the venture capital market, to know more about this field. We believe that it is fairly easy to imagine that as long as the company has a great product or technique the rest will work out, but this is an opinion that has been clearly refuted by our interview respondents. Crucial elements are rather directly related to the persona of the people within the venture management team.

It would be rewarding to try to combine psychological and sociological theories with more traditional economic theories, such as the principal-agent theory, to be able to work out models of how to measure and test if the venture management team is suitable. A key element would be a method of how to detect and measure trustworthiness and how to ensure that the persons are fully committed to the project but at the same time willing to step aside once the company has reached a certain stage and is in need of other type of competences. The latter is admittedly difficult but we believe that by using sophisticated psychological and sociological methods it might be possible to find out if the persons have strong need for control, are status driven and unlikely to accept not to be part of the top management anymore etc. Thereby it could be determined how likely it is that the venture management team would interfere with the future overall development of the company. Being a good judge of character seems to be very important in order to be successful as a venture capitalist, it is therefore of practical use as well to try to find a model that takes personality traits into account.

The complex relationship between the venture capitalist and the venture management team is most definitely a multidisciplinary field of study. It needs a great focus, not only on the traditional economic theories, but also on the sociological and psychological perspectives, in order to grasp the underlying factors of the interaction between these actors within the venture capital market.

References

Articles

Akerlof GA, 1970, *The Market for ”Lemons”: Quality Uncertainty and the Market Mechanism,* The Quartely Journal of Economics, Vol. 84, pp. 488-500

Amit R, Brander J, Zott C, 1998, *Why do venture capital firms exists? Theory and Canadian evidence*, Journal of Business Venturing, Vol. 13, pp. 441-466

Busenitz LW, Moesel DD, Fiet JO, Barney JB, 1997, *The framing of perceptions of fairness in the relationship between venture capitalists and new venture teams*, Entrepreneurship Theory and Practice, Vol. 21, pp. 5-21

Busenitz LW, Moesel DD, Fiet JO, 2005, *Signaling in Venture Capitalist- New Venture Team Funding Decisions: Does It Indicate Long-Term Venture Outcomes?,* Entrepreneurship Theory and Practice, Vol. 29, pp. 1-12

Carr JB, Brower RS, 2000, *Principled opportunism: evidence from the organizational middle*, Public Administration Quarterly, Vol. 24, pp. 109-138

Chiles TH, McMackin JF, 1996, *Integrating Variable Risk Preferences, Trust, and Transaction Cost Economics,* Academy of Management Review, Vol. 21, pp. 73-99

Dimov D, Clercq De D, 2006, *Venture Capital Investment Strategy and Portfolio Failure Rate: A Longitudinal Study,* Entrepreneurship Theory and Practice, Vol. 30, pp. 207-223

Drummond H, 2002, Living in fool's paradise: *The collapse of Baring's Bank*, Management Decision, Vol. 40, pp. 232-238

Eisenhardt KM, 1989, *Agency Theory: An Assessment and Rewiew,* The Academy of Management Review, Vol. 14, pp. 57-75

Granovetter M, 2005, *The Impact of Social Structure on Economic Outcomes*, The Journal of Economic Perspectives, Vol. 19, pp. 33-50

Granovetter M, 1985, *Economic Action and Social Structure: The Problem of Embeddedness,* American Journal of Sociology, Vol. 91, pp. 481-510

Husted BW, 2007, *Agency, Information, and the Structure of Moral Problems in Business,* Organization Studies, Vol. 28, pp. 177-195

Husted BW, 1994, *Transaction costs, norms, and social networks,* Business and Society, Vol. 33, pp. 30-58

Kelly P, Hay M, 2001, *Helping hand or watchful eye? An agency theory perspective on private investor involvement in entrepreneurial ventures,* Paper presented at the Babson-Kaufman Research Conference, Jönköping, Sweden

Lavrač N, Ljubič P, Urbančič T, Papa G, 2007, *Trust Modeling for Networked Organizations Using Reputation and Collaboration Estimates,* IEEE Transactions on Systems, Man and Cybernetics, Part C Applications and Reviews, Vol. 37, pp. 429-439

MacMillan IC, Zemann L, Subbanarashima PN, 1987, *Criteria distinguishing successful from unsuccessful ventures in the venture screening process,* Journal of Business Venturing, Vol.2, pp. 123-138

Mosser M, 2000, *The rogues among us*, Futures: News, Analysis & Strategies for Futures, Options & Derivatives Traders, Vol. 29, pp. 76-79

Muzyka D, Birley S, Leleux B, 1996, *Trade-offs in the investment decisions of European venture capitalists*, Journal of Business Venturing, Vol. 11, pp. 273-288

Ojala M, Hallikas J, 2006, *Investment decision-making in supplier networks: Management of risk,* International Journal of Production Economics, Vol. 104, pp. 201-213

Osnabrugge Van M, 2000, *A comparison of business angel and venture capitalist investment procedures: an agency theory-based analysis,* Venture Capital: An International Journal of Entrepreneurial Finance, Vol. 2, pp. 91-109

Pintado TR, Lema de DGP, Auken Van H, 2007, *Venture Capital in Spain by Stage of Development*, Journal of Small Business Management, Vol. 45, pp. 68-88

Porras ST, Clegg S, Crawford J, 2004, *Trust as Networking Knowledge: Precedents from Australia,* Asia Pacific Journal of Management, Vol. 21, pp. 345-363

Riding AL, Duxbury L, Haines G, 1995, *Financing enterprise development: decision-making by Canadian angels*. School of Business, Carleton University, Ottawa.

Riquelme H, Rickards T, 1992, *Hybrid Conjoint Analysis: An Estimation Probe in New Venture Decisions*, Journal of Business Venturing, Vol. 7, pp. 505-519

Sapienza HS, Gupta AK, 1994, *Impact of agency risks and task uncertainty on venture capitalist - ceo interaction,* Academy of Management Journal, Vol. 37, pp. 1618-1632

Tyebjee TT, Bruno AV, 1984, *A Model of Venture Capitalist Investment Activity,* Management Science, Vol. 30, pp. 1051-1067

Ulhøi JP, 2007, *Revisiting the principal-agent theory of agency: comments on the firm-level and cross-national embeddedness theses,* Journal of Organizational Behavior, Vol. 28, pp. 75-80

Uzzi B, 1996, *The Sources and Consequences of Embeddedness for the Economic Performance of Organizations: The Network Effect,* American Sociological Review, Vol. 61, pp. 674-698

Zopounidis C, Siskos Y, Pouliezos A, 1994, *An integrated DSS for financing firms by an industrial development bank in Greece*, Decision Support Systems, Vol. 12, pp. 151-168

Literature

Alvesson M, Sköldberg K, 1994, *Tolkning och reflektion : vetenskapsfilosofi och kvalitativ metod*, Studentlitteratur

Andrén N, Ericsson T, Hansson S, 2003, *Finansiering*, Liber Ekonomi

Bengtsson L, Nygaard C, 2001, *Strategizing-en kontextuell organisationslära*, Studentlitteratur

Bryman A, Bell E, 2005, *Företagsekonomiska forskningsmodeller*, Liber Ekonomi

Elg U, Johansson U, 2000, *Dynamiskt relationsbyggande i Europa*, Lund Business Press

Isaksson A, 1999, *Effekter av venture capital i Sverige*, NUTEK B 1999:3

Isaksson A, 2000, *Venture capital begrepp och definition,* Svenska Riskkapital Föreningen

Jacobsen DI, 2002, *Vad, hur och varför,* Studentlitteratur

Lindholm Dahlstrand Å, 2004, *Teknikbaserat nyföretagande : tillväxt och affärsutveckling,* Studentlitteratur

Lindström G, Olofsson, 2002, *Affärsänglar och teknikbaserade tillväxtföretag*, SNS Förlag

Ogden JP, Jen FC, O'Connor PF, 2003, *Advanced corporate finance: policies and strategies*, Prentice Hall

Sarantakos S, 2005, *Social Research*, Palgrave Macmillan

SCB, 2002, *Om olika ansatser för att spegla det nya i ekonomin*, Statistiska centralbyrån

Simon HA, 1957, *Administrative Behavior*, The Macmillan Company

SVCA, 2007, *Den svenska private equity- marknaden*, Svenska riskkapitalföreningen

Williamson OE, 1975, *Market and Hierachies: Analysis and Antitrust Implication*, Free Press

Electronic resources

(http://www.nutek.se/sb/d/147) 2007-05-10

(http://www.svca.se/home/page.asp?sid=337&mid=2&PageID=23788) 2007-05-10

(http://www.svca.se/home/page.asp?sid=337&mid=2&Id=124) 2007-05-12 (http://www.eqt.se/Page____5.aspx?epslanguage=EN) 2007-08-15

(http://www.innkap.se/default.aspx?page=400) 2007-08-15

(http://www.ingeniousmedia.co.uk/flash.htm) 2007-08-15

Interviews

Håkan Nelson, Chief Executive Officer, Malmöhus Invest, Malmö, face-to-face, 2007-05-15

Per Heander, Investment Manager, Teknoseed, Lund, face-to-face, 2007-05-07

Nicholas Jacobsson, contact person for Connect Skåne, Lund, face-to-face, 2007-05-08

Anders Hättmark, contact person for Business Angel Syd, telephone, 2007-05-09

Cecilia Elofsson, Investment Consultant, ALMI Företagspartner, Malmö, face-to-face, 2007-08-23