Private Investors and Entrepreneurs:
How Context Shapes Their Relationship

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Submitted in partial fulfillment for the degree of PhD
March 2000

UNIVERSITY OF LONDON
Abstract of Thesis

See over for notes on completion

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Title of thesis Private Investors and Entrepreneurs: How Context Shapes Their Relationship

Degree PhD

In this thesis, a model is developed and empirically tested with the aim of identifying critical contextual factors that shape the structure of the economic relationship between private investors and entrepreneurs. Transaction cost economics and agency theory are potentially useful theoretical perspectives to understand the difficult issues of how to structure relationships between two parties who may have divergent interests and goals.

The predictor variables include measures of specific attributes of the contracting parties and of the transaction itself. The dependent variable, governance effort, is measured in two distinct ways based on: i) the nature of the contractual relationship struck with the entrepreneur ex ante, and ii) the anticipated level of investor interaction with the management team ex post.

Survey data was collected from 106 private investors in the UK identified through: i) personal search efforts, ii) Venture Capital Report, and iii) various business introduction services. Multiple regression was used as a basis for testing individual hypotheses. The utility of extending the transaction cost economics and agency theory perspectives into the domain of informal venture capital is also assessed.

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Acknowledgements

In many ways, the process of completing a dissertation is a very similar one to that of starting a venture. One needs to find a unique selling proposition, has to "sell" the idea to a thesis transfer committee, map out a strategy for delivering it, raise the necessary resources to see it through, and, importantly, successfully "exit" from the process. As with any venture building process, nothing ever "goes according to plan" and this exercise was no different in that respect. While the binding gives the impression that this dissertation was a "solo effort", I could not have successfully "achieved exit" without the ongoing support of a number of people at critical points along the way.

To my supervisor, Michael Hay, I owe the greatest debt of thanks. London Business School is indeed fortunate to have such a talented individual who can so eloquently bridge the gap between theory and practice that is such an essential ingredient to entrepreneurship research. Michael, you have been unstinting in your support throughout this process and I look forward to strengthening the bond of our friendship in the years to come.

To my faculty colleagues at London Business School, John Bates, Rob Johnson and Maurice Pinto, the practical experience and insights you have shared with me over the years has immeasurably improved the quality of this work. I thank you all for keeping my research "firmly rooted in practice".

To Ian Laing and Michael Stoddart, for the inspiration to undertake research that was meaningful, relevant and challenging. It was my good fortune to come to a place that can be a magnet for successful individuals like you. Having a supportive framework like the Foundation for Entrepreneurial Management in place has been a tremendous stimulus for me both personally and professionally and I look forward to working with both of you in the coming years.

To the many friends and colleagues I have made along the way including Erkko Autio, Harry Sapienza, James Almeida, Toivo Koski, Jonathan Levie, Bill Bygrave, Dan Muzyka, Sue Birley, Pedro Nueno, Ginny Batten, Jo Freeman, Hennie Escoffier and countless others, my sincerest thanks for "pushing me along".

To my examiners, Gordon Murray and Colin Mason, your insightful comments and feedback have immeasurably enhanced the quality of the finished product. I look forward to having the opportunity to push the frontiers of entrepreneurship research as you have both done and continue to do.

To my family and friends in Canada, although I have completed this work from "a distance", you were all a great source of strength and inspiration in knowing that your thoughts were always with me along the way. I especially want to dedicate this dissertation to my parents who have waited a long time to welcome "the first doctor into the family". Along this journey, my brother Brian and "second mom" Sophie passed away. This dissertation is also dedicated to your memory. Finally, I look forward to sharing my life with two very special people who I met along the way. To my best friend and future wife, Tiina, your love has meant more to me than anything else in the world. I shall also be forever thankful to my stepson, Julius, for the inspiration that comes from being an inquisitive and fun-loving five-year old. I dedicate this dissertation to both of you.

CHAPTER 1: INTRODUCTION

> "The existence of a continuing finance gap for small firms has been the subject of ongoing debate in many countries (including the United Kingdom). This (financing) gap is particularly identified with a shortage of equity capital, and is experienced most sharply by certain types of firm (notably high technology ventures) at particular stages of development (especially those looking for seed and start-up capital)...." (Harrison and Mason 1996a: xix)

For entrepreneurial ventures, the search for equity capital to support growth and development appears to be a persistent and enduring problem in the United Kingdom. The perceived "equity funding gap" faced by firms in their early stages of development requiring relatively modest infusions of capital (usually under £500,000) has been noted in a number of high profile government reports (Macmillan Committee 1931; Bolton Report 1971; Wilson Report 1979; ACOST 1990). The Confederation of British Industry (1993) and, more recently, the Institute for Public Policy Research (Gavron et.al 1998) have also made mention of the difficulties faced by entrepreneurs raising small amounts of equity capital, particularly in the early stages of development of their ventures. Who should be expected to "fill" the equity gap? Why does the equity gap persist? There is growing recognition that in view of their experience building entrepreneurial businesses and their desire to be "hands on" investors that private investors are best positioned to potentially address this funding gap. However, our understanding of why this gap persists and what might be done to alleviate the problem is still largely undeveloped.

In this introductory chapter, we will:

- Explain why private investors, as opposed to banks or venture capital funds, are so well placed to potentially address the equity funding gap
- Discuss some of the underlying contributing factors that may explain why the equity funding gap persists
- Establish the rationale for undertaking this study

- Specify the objectives of this research project
- Highlight reasons why this study is important for practitioners, policy-makers and researchers
- Provide an outline of the structure of the chapters that follow

1.0 Who Should "Fill" the Equity Funding Gap?

After funds provided personally and/or from close friends and family members (so called "love money") are exhausted, to whom can an entrepreneur turn to raise finance to support growth? In the first instance, many entrepreneurs attempt to raise "quasi-equity" debt finance from their banker (Birley and Muzyka 1997). Often lacking sufficient tangible security to support the requested advance and an established track record of firm profitability, bankers find it difficult to support loans which are, in effect, a substitute for equity in the company's balance sheet. To them, over-reliance on debt finance can also place enormous financial strain on a business particularly when difficult trading conditions are experienced or when the broad economic climate in which the firm operates turns unfavorable. Moreover, commercial banks rightfully argue that a return based on the spread between interest earned and cost of funds to depositors does not sufficiently compensate them for taking on what amounts to equity risk.

On the face of it, venture capital funds appear to be better suited and are more appropriately compensated for making equity investments in entrepreneurial firms. A large body of received research has also demonstrated that venture capitalists are "value-added investors" contributing more than merely capital in support of the venture's development by: i) acting as a sounding board for management, ii) making introductions to potential suppliers and customers, iii) facilitating the process of raising additional capital, and iv) advising as to the manner and timing for realising the value being created within the firm, among others (Sapienza 1989). Committing relatively modest sums of capital at a very early stage and working very closely with the venture post investment both as a means of managing risk and ensuring that the firm is "investment ready" for follow-on finance is the very essence of the "classic venture capital" model (Bygrave and Timmons 1992). In practice, however, "classic" venture capital has given way to "merchant" capital, particularly in Europe, with venture capitalists channeling the bulk of funds into lower risk, later stage management-buy in and buy-out opportunities.[1] What factors are responsible for this shift in investment focus, particularly in the United Kingdom?

A number of "structural biases" have been identified which go some way to explaining the observed shift in the pattern of venture capital investment in the United Kingdom away from early stage and/or smaller investment proposals. First, most venture capital funds are often raised as limited partnerships of fixed duration, usually ten years. Coupled with an incentive structure that rewards fund managers with a share of capital gains (the "carried interest"), there is a built in structural bias for fund managers to invest as much as possible as quickly as possible. Second, in support of further fund-raising activities, venture capital managers must be able to demonstrate tangible investment performance to potential fund providers. Faced with such pressure, the focus on lower risk, later stage investments offering the prospect of capital gains realisation in a relatively short period of time (3 to 5 years typically) is understandable. Third, venture capital funds maintain that the costs associated with verifying information provided to them and legally documenting deals are largely fixed irrespective of investment size, thus creating a further bias towards making larger investments. Aside from these financial costs, the development needs of ventures are particularly acute in the early stages which necessitates close and intense interaction between investor and entrepreneur. In this respect, fund managers potentially face severe time constraints in building and maintaining a diversified portfolio of early stage investments.

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[1] At its peak in 1989, early stage investments accounted for nearly 40% of all venture capital investments made by number and more than 15% of total capital invested in that year by UK based venture capital funds. By 1996, early stage investments represented only 20% of all venture capital deals by number and 5% of total capital invested.

For these reasons, fund managers have argued that the "economics" of venture capital investing are inherently biased against providing "classic venture capital" (Murray 1994). Thus, there appears to be some very plausible reasons for us to conclude that venture capital funds are not well placed to address this equity-funding gap.

In many countries throughout the world, there is a growing realization that private individual investors, so called business angels, are well positioned to play a vital role in bridging the gap between "love money" and "venture capital". Collectively, this group of largely self-made individuals who either have invested or intend to invest their own funds into a privately-held firm are referred to as the informal venture capital market. Whether the descriptors "informal" and "market" are indeed applicable in this context is an open question that we seek to address in this study. By most measures[2], the informal venture capital market is the largest source of equity finance for privately-held ventures in the United States (Freear, Sohl and Wetzel 1997) and the United Kingdom (Coveney and Moore 1998). For example, in the United Kingdom, there are estimated to be 50,000 private investors who, on an annual basis, invest in thirty to forty times more businesses than do venture capital funds (van Osnabrugge 1998b).

Like venture capital funds, private investors are attracted to growth opportunities that offer substantial capital gains upside and that are pursued by driven and qualified management teams. Both private investors and venture capital fund managers work closely with the venture in a number of capacities both as a means of promoting and protecting their interests as significant shareholders. Unlike venture capital funds, private investors do not "have to invest" and are answerable only to themselves for their investment decisions (Benjamin and Margulis 1996). Moreover, most private investors have built an entrepreneurial business of their own, a background that differs significantly from that of most European

[2]Based on number of market participants, investments made, total capital committed, and capital available for investment.

venture capitalists who are, more often than not, accountants, bankers or lawyers by training. Private investors also appear to be much more actively involved post investment, as a result, the typical portfolio size of a private investor is also smaller as compared to most venture capital funds. As we shall discuss in the next chapter, private investors appear to have assumed the role of "classic venture capital" both in terms of the nature of their investment focus on small, early stage proposals and the close personal involvement they maintain with the venture post investment. Against this backdrop, it should not be surprising to learn that one of the conclusions reached in a report prepared for the United Kingdom government was that: "... an active informal venture capital market is a prerequisite for a vigorous enterprise economy" (ACOST 1990: 41).

In many respects, the informal venture capital market represents both an enormous pool of funds and a large reservoir of potentially relevant experience and valuable expertise for entrepreneurial firms seeking capital. Yet despite its prominence and perceived importance, particularly as a source of vital early stage capital, the full potential of the market is not fully realised. The equity gap appears to still persist in view of the difficulties reported by entrepreneurs in securing equity finance *and* the excess supply of funds available to invest on the part of investors. Why does this perceived equity-funding gap persist?

1.1 The Persistence of the Equity Gap: Contributing Factors

From the standpoint of an entrepreneur seeking equity finance from private investors and/or venture capital funds, one can argue that many will always perceive the existence of an equity-funding gap so long as there are proposals that fail to attract equity funding. Previous research has demonstrated that both private investors (Mason and Harrison 1994a 1996b) and venture capital funds (Fried and Hisrich 1995) reject the vast majority of opportunities presented to them during the screening phase. While the reasons for rejection vary from deal-to-deal, two contributing factors that are cited most often are "inappropriateness" and "lack of faith in management" (Mason and Harrison 1994a). While concerns about management can potentially be addressed by attracting additional talent into the founding team, finding an "appropriate" investor implies the existence of mechanisms to identify and access all potential capital suppliers. In theory, the existence of an efficient market implies that buyers and sellers are fully informed as to alternatives, incur minimal search costs to find each other, and there are minimal transaction costs to effect the exchange. In practice, as will be discussed at greater length in Chapter 3, the "market" for informal venture capital appears to be quite different in character to the concept of markets espoused in theory.

First, in theory, markets should be highly visible in nature. To a large extent this observation holds true with respect to the formal venture capital market as directories of market participants and contact details are maintained, regularly updated and publicly accessible. However, the same can not be said of the informal venture capital market where in an effort to preserve the anonymity of participants as a means for controlling the volume of their deal flow, no such directories are either maintained or readily accessible. In this respect, the informal venture capital market is largely invisible in nature. Hence, the task of matching the "right opportunity" with the "right investor" still appears to be a matter of serendipity, an observation that implies large search costs for both parties. The establishment of mechanisms to facilitate the search process such as business introduction services who direct deal flow to investors on a confidential basis has helped to address this problem (Harrison and Mason 1996b). Having said this, so long as investors value their anonymity and entrepreneurs express concerns about disclosing potentially sensitive competitive information about their venture, supply and demand will fail to meet and the perceived equity-funding gap will persist.

In addition to problems related to finding each other, there is reason to believe that the flow and content of information between and among the parties is hampered and deficient in a number of respects, all of which serve to reduce the volume of completed transactions. First, in an effort not to disclose commercially sensitive information, entrepreneurs are often reticent to speak freely with investors about a given opportunity in the fear that investors will use such information to their own advantage (Cable and Shane 1997). This perceived threat may be particularly pronounced vis-à-vis private investors, many of whom have developed entrepreneurial businesses of their own. The importance of an investor being "fully informed" is borne out by research findings that suggest that the perceived quality of information received is both a major "deal-breaker" (Mason and Harrison 1994a) and a potentially important stimulant for further investment activity (Coveney and Moore 1998). Second, there also appears to be restricted flow of information among investors, particularly between those who have completed at least one investment and those who have not, as to how to negotiate and close a private equity transaction. Finally, there is a widely-held belief on the part of many entrepreneurs that raising equity finance necessarily entails the loss some degree of managerial control over day-to-day operations (Hay and Khamshad 1994). While largely stemming from a concern to maintain the firm at a "manageable size", there is reason to believe that some entrepreneurs are neither fully informed as to the benefits of raising equity capital to support growth or of the terms and conditions upon which such finance can be obtained. The flow of information within and between participants is a necessary lubricant for transactions to take place. To the extent that better information could encourage more entrepreneurs to seek out equity finance and investors to fund more deals, the number of completed market transactions is lower than might otherwise be the case and one can conclude that "supply" and "demand" fail to meet.

Third, it also appears that private equity transactions by their very nature imply the incurrence of large transaction costs. By virtue of the fact they are investing in a highly illiquid instrument whose value is tied so intimately with a specific individual, the entrepreneur, investors face inefficient replacement markets and thus are unable to easily switch options (Cable and Shane 1997). Aside from the tangible costs associated with due diligence activities, there is mounting evidence that potential transactions break down due to disagreements between the parties over the terms and conditions of the deal (Mason and Harrison 1994a; Smith 1994; Hay and Khamshad 1994). Of perhaps greater significance, however, is that private investors display a proclivity to be very actively involved in the development of the businesses in which they invest (Harrison and Mason 1992b). We would maintain active investor involvement with the venture is, in essence, a form of ongoing transaction cost, particularly if viewed as a means for compensating the inability to write comprehensive contracts with the entrepreneur up front (van Osnabrugge 1999). While syndication affords the opportunity for an investor to share some of these transaction costs with others, a portion of these costs are borne by the investors themselves. In view of the foregoing, it appears that private investors are very selective about which opportunities to back and are preoccupied with avoiding failures in view of the associated financial and temporal opportunity costs involved (Benjamin and Margulis 1996).

The domain of the private investor appears to require significant effort on the part of investors and entrepreneurs to find each other, once identified to evaluate the merits of becoming partners, and once decided to determine how the relationship between them is to be structured. It is important to note that in describing the informal venture capital market as a "market", we are making a presumption that it shares certain structural characteristics to other markets, such as spot markets for commodities. Whether the markets for entrepreneurial talent and private equity behave in such a manner is an open issue and one that must be kept in mind in choosing to rely on two theoretical perspectives, transaction cost economics and agency theory, that have been developed, in large measure, to explain dynamics in generally "better informed" and "more visible" market settings. As we will discuss in Chapter 3, we should not dismiss potential utility out-of-hand as the need for more theoretically grounded frameworks in the informal venture capital field is a pressing one. Bearing the eccentricities of the informal venture capital phenomenon in mind, we hope to be able to provide some insights into whether the transaction cost economics and agency theory thinking can be usefully extended into the field and may serve to highlight the identification of other promising and more "appropriate" theoretical lenses. What needs is this proposed study addressing? It is to this issue that we now turn.

1.2 Defining the Need for this Study

By virtue of the discrete nature of the phenomenon, it would appear that the search process for investors and entrepreneurs is inherently a difficult and challenging one. A great deal of research has been undertaken to explore mechanisms to facilitate the search process for entrepreneurs while still retaining anonymity for investors (Sohl 1999). As was highlighted in the previous section, there are reasons to believe that the flow and content of information among and between investors and entrepreneurs is deficient and that private equity transactions imply the incurrence of significant transaction costs. Comparatively little research has been undertaken to date, that is both theoretically grounded and deal specific in nature, to explore the factors that investors take into account in determining how to structure their relationship with the entrepreneur. Negotiating and coming to agreement as to the "terms of the deal" appears to be no small task, particularly for investors, for a number of reasons:

- the future performance of the venture is highly speculative as key market and technological uncertainties remain largely unresolved at the time of investment (Sapienza 1989);
- faced with time and financial constraints, investors often are unable to undertake as much due diligence evaluating the information provided to them by the entrepreneur as might be warranted;
- investors are not able to fully and objectively assess the capabilities, aptitudes and intentions of the entrepreneur seeking capital and, hence, must rely on a measure of trust that they will act with their best interests in mind;
- the valuation of equity stakes in privately and closely-held ventures is admittedly a difficult task;
- the inability of investors to either continually observe the entrepreneur's behavior or discern underlying cause effect relationships with certainty;
- by holding an equity stake that is highly illiquid in nature, investors are effectively denied the option, as is available to shareholders in publicly-listed companies, to signal their

displeasure with the actions of management by selling their equity stake at fair market value and expediently; and

- given the highly imperfect nature of the markets for entrepreneurial talent (Cable and Shane 1997), it becomes effectively impossible to replace the entrepreneur; replacing management is another option available to and viable for the board of directors of publicly-listed companies.

In their article, "The Informal Venture Capital Market: Milestones Passed and the Road Ahead," Freear, Sohl and Wetzel (1997) identified a number of potentially fruitful lines of future research inquiry for the field including:

- the need to refine the theoretical foundations of the field through empirical tests of models developed on the basis of theories developed in other fields of study;
- the discovery of information on the pricing and terms and conditions of informal venture capital deals; and
- better evidence defining the ABCs (attitudes, behaviors and characteristics) of private investors.

The proposed study will focus on all three of these issues. By relying on theoretical perspectives developed in the field of industrial organization, specifically transaction cost economics and agency theory, we will develop a model to empirically test the relationships between contextual factors and the choices investors make with respect to how to structure their relationship with the entrepreneur. By collecting information on the specific terms and conditions of actual deals, we shall begin to address the second area identified. By carefully designing our sample frame, we hope to be able to tap into the heterogeneity of the market and further develop our understanding of the behavior of market participants. Having said this, we must recognise that informal venture capital is an emerging field of study. Relatively few studies (Landström 1992; Riding, Duxbury and Haines 1994; Fiet 1991 1995a 1995b; Harrison, Dibben and Mason 1996; van Osnabrugge 1998a 1998b 1999, Landström, Manigart, Mason and Sapienza 1998) have relied on theoretical perspectives from other fields of study as a guiding framework. In this respect, this study as with any other in this emerging field, is exploratory in nature. Though exploratory, this research study does address a number of significant development needs of the informal venture capital field as identified above.

1.3 Defining the Objectives of this Study

The objectives of this study can be summarized as follows:

- to develop a theoretically grounded framework to test the influence that various contextual factors pertaining to the background of the transactors and specific attributes of the investment itself has on the decisions made by the investor on how to structure the contractual relationship with the entrepreneur up front and the intensity of their intended involvement with the venture post investment;
- to explore the distinction to be drawn between "managerial" and "equity" control by examining the contractual structure of the relationship to discern areas where specificity is sought and/or ambiguity tolerated by investor(s);
- to examine the influence that interpersonal trust between the parties has on the choices made by investors as to how the relationship with the entrepreneur is structured;
- to assess whether the transaction cost economics and agency theory perspectives are useful theoretical lenses in the domain of informal venture capital; and
- to gain insights into whether the modifiers "informal" and "market" are appropriate descriptions of the underlying phenomenon.

An overarching objective of this study, as with any other in entrepreneurship, is to undertake a project that is meaningful and of benefit to practitioners and policy-makers in addition to making a positive contribution to our existing stock of knowledge. Why does this research project matter? It is to this issue that we now turn.

<u>The Importance of this Study to Practitioners</u>

By collecting detailed information on a deal specific basis, this study will provide insights for investors, both for those that have completed numerous deals and in particular for the substantial minority of individuals who have yet to complete their first private equity transaction, the "virgin investors". Aside from being able to compare their approach to structuring deals with that of their peers, the most salient insights of this study for active market participants are perhaps those related to our examination of syndicated investments involving other private investors and/or venture capital funds. Syndication affords investors the opportunity to widen their network of contacts to uncover promising investments, broaden their base of experience in evaluating the merits of specific proposals, and achieve some measure of diversification by participating in more (and larger) deals than might otherwise be the case acting on their own. Understanding the nuances of how syndicates "operate" is important as there is growing appreciation that the composition of syndicates can change quite dramatically from deal-to-deal (Benjamin and Margulis 1996) and that the "hand-off" between the informal and formal venture capital markets is not altogether straightforward (Sohl 1999). The findings of this study may serve to provide further "lubrication" for syndicate formation and enhance the development of complementary relationships with venture capital funds (Freear, Sohl and Wetzel 1990). For "virgin investors", by tapping into the experience of active market participants, we will provide insights into the issue of how to structure and manage their relationship with the entrepreneur. It is not for lack of capital but of their confidence in knowing how to "do a deal" that appears to hold back virgin investors from consummating their first investment (Coveney and Moore 1998). We hope that the findings of this study will serve to stimulate additional flows of investment from this substantial but inactive market segment.

For entrepreneurs, the findings of this study will provide a basis for making them more "informed" seekers of capital. We hope to identify the key issues over which investors seek to exert some measure of influence and importantly those over which the entrepreneur can exercise their own discretion. The findings of this study may thus serve to "level the playing field" for entrepreneurs in their negotiations with potential investors. Perhaps more importantly, in trying to understand the underlying factors investors take into account in determining how to structure their relationship with the entrepreneur, this study should provide further insights into the issue of "who" and "how" to approach. In providing detailed deal specific information, it is our hope that more entrepreneurs will seek out capital, however, being "better informed" does not necessarily imply a shift in widely-held belief that capital can not be obtained on "reasonable terms" (Hay and Khamshad 1994).

The Importance of this Study to Public Policy-Makers

Based on the pioneering work of Professors Mason and Harrison, the Government in the United Kingdom has both appreciated the importance of the informal venture capital market and been highly supportive of initiatives to reduce search costs for the parties and further stimulate the level of investment activity through the provision of tax related incentives to private investors. However, like researchers in the field, public policy-makers face the challenge of coping with a phenomenon that is largely invisible to the eye. Some authors have maintained that private investors are in the relationship building business actively seeking to broaden their base of contacts among potential sources of deal flow and finance alike (Benjamin and Margulis 1996). Over time, as the breadth and depth of relationships developed and the number of completed investments increases, it appears that the need for "public" sources of deal flow also diminishes (Kelly and Hay 1999). Put another way, the attraction of "public gateways", such as business introduction services may be particularly compelling for investors who are in the formative stages of developing their own networks of contacts and thus likely have a limited base of experience investing in privately-held firms. To the extent that this line of reasoning holds, a potentially important role for business introduction services is in educating novice investors and entrepreneurs alike about the process of investing in and raising equity privately. These services also appear to have a crucial networking role to play in facilitating the formation of investment syndicates in addition to being a platform for showcasing potential opportunities. By tapping into the experience of active market participants on a deal specific basis, the findings of this study should serve to support the educational and training programs being developed by many of these intermediary organizations. Of particular interest will be the findings of this study with respect to understanding how and why syndicated deals are structured the way they are.

The Importance of this Study to Research

For research, this study is important for three distinct, but interrelated, reasons. First, we will begin to draw the lines of distinction between the concepts of "managerial" versus "voting" control. This issue is a central concern in the field of entrepreneurial finance, particularly so as entrepreneurs are crucially reliant on external financial (and other) resources to support their venture's growth and development. A number of studies have highlighted that investors do attach "contractual strings" to their deals, that they often interact closely with the venture post investment, and that they contribute to the venture's development in a variety of ways (Ehrlich, DeNoble, Moore and Weaver 1994; Harrison and Mason 1992b; Riding, Duxbury and Haines 1994; Steier and Greenwood 1995; NatWest 1998). Very few studies have systematically examined the linkages that may exist between the attributes of the contracting parties, the characteristics of the deal itself and the specific choices made as to how the relationship between the investor and entrepreneur is structured ex ante and/or monitored ex post (Barney, Busenitz, Fiet and Moesel 1994; Norton 1990; Norton and Tenenbaum 1993b; Landström, Manigart, Mason and Sapienza 1998).

Second, the informal venture capital field is admittedly an emerging area of study where, in many respects, we are still trying to establish "...some boundaries on our ignorance" (Wetzel 1986: 132). The field is also a nascent one with respect to the development of its theoretical underpinnings. This study will introduce an element of theoretical rigor by relying on two theoretical perspectives developed in the field of strategic management as a basis for model development (discussed in detail in Chapter 4). By empirically testing this model with deal specific data on actual investments, we hope to gain insights into the decision-making process used by investors in the crucial formative stages of relationship development with the entrepreneur, the period leading up to and including the completion of shareholder agreements.

Third, on the face of it, the transaction cost economics and agency theory perspectives (Eisenhardt 1989) hold out promise as potentially useful theoretical lenses that can be extended to the domain of informal venture capital. There are reasons to believe, however, that these perspectives may be ill-suited to firms with closely-held private shareholding structures *and* to economic relationships that are infused with a high degree of interpersonal trust between the contracting parties (Ghoshal and Moran 1996). In addition, private equity transactions are highly asset specific in nature with respect to the backgrounds and experience of both parties to the exchange (Cable and Shane 1997). As will be discussed in greater detail in Chapter 3, the domain of informal venture capital appears to be quite different from that in which both the transaction cost economics and agency theory perspectives have been developed. A key issue that we hope to address in this study is to assess whether these theoretical lenses can be usefully extended into the informal venture capital field. In addition, we hope to gain some insights into the influence that trust has on the observed structural relationships.

1.4 The Organization of this Study

The remaining seven chapters of this study are organized as follows. In Chapter 2, we will provide a comprehensive international overview of the received research in the field of informal venture capital. The methodological challenges of undertaking research in an area where the population is largely invisible are highlighted and the existing gaps in our knowledge base identified. In Chapter 3, the two theoretical lenses, transaction cost economics and agency theory, that are relied on to develop a model are reviewed. The merits and limitations of extending the use of these two complementary perspectives into the domain of informal venture capital are discussed and the empirical work in the field of entrepreneurial finance that has relied on either or both of these lenses summarized. In Chapter 4, we develop a model of the linkages between our dependent variable (governance effort) and a number of contextual independent variables. The dependent variable is measured in two distinct ways: i) the nature of the contractual deal that is struck with the entrepreneur ex ante (CONTRACT), and ii) the anticipated level of investor interaction with the venture ex post (CONTACT). Three relative experience, two investor related and seven deal attribute predictor variables are introduced as are two control variables (travel time from the investor's home base *and* the venture's stage of development) to aid subsequent analysis. In Chapter 5, the research methodology employed in this study is discussed in detail including: ii) the development of a survey instrument, ii) the decisions taken to identify a suitable sample of respondents, iii) the specification of individual constructs, iv) the statistical methodology employed to test the model, and v) the merits and limitations of the research design. The results of our statistical analyses are presented in Chapter 6 followed by a broader discussion of the findings of our study in Chapter 7. In the concluding chapter 8, the contributions and limitations of this study to practitioners, policy-makers, and the research community alike will be discussed. A number of fruitful lines of future research inquiry will also be highlighted. It is to a review of the informal venture capital field that we now turn.

CHAPTER 2: INFORMAL VENTURE CAPITAL: AN OVERVIEW

"It's (informal venture capital) not a new phenomenon, of course, Henry Ford's auto empire was launched thanks to five (business) angels who plunked down about $40,000 in 1903." (Conlin 1989, 32)

In Chapter 1, we briefly alluded to the importance and significance of the informal venture capital market as a source of equity finance for entrepreneurial ventures. Leading authorities in the field of informal venture capital have suggested that the development of a body of knowledge occurs in three overlapping stages (Freear, Sohl and Wetzel 1997). In the first stage, researchers establish whether a particular area is one worthy of study. In the second, researchers collect empirical evidence about the subject matter, interpret and disseminate their findings, and explore the linkages that may exist with other allied areas of enquiry. In the final stage, explanatory and predictive theories are developed based on the interpretation of evidence collected in the field and research undertaken in related fields. The authors conclude that research in the informal venture capital area has progressed through the first two stages and is beginning to penetrate the third.

The objective of this study is four-fold: i) to integrate the insights developed in the field of industrial economics, specifically the transaction cost and agency theory perspectives, into a predictive model aimed at gaining a more thorough understanding of the issue of how private investors choose to structure their economic relationship with the entrepreneur; ii) to assess whether these theoretical lenses are appropriate in the informal venture capital area; iii) to explore the influence of trust in our model; and in doing so; iv) contribute to the growing stock of knowledge in the informal venture capital field. With a view to placing this research project into context, we shall provide a comprehensive overview of the informal venture capital as a field of enquiry. A review of the relevant literature pertaining to the two theoretical lenses, transaction cost economics and agency theory, which will be relied upon in the development of a predictive model will be discussed at length in

Chapter 3. In Chapter 4, we will develop a model relying on the transaction cost and/or agency theory perspectives as appropriate. It is to the issue of informal venture capital to which we now turn.

2.0 Introduction

Aside from funds provided from personal resources and by close family and friends, so called "love money", private individuals are the largest source of equity finance for entrepreneurial firms. Despite its importance, the informal market for venture capital is both demonstrably inefficient and, for all practical purposes, largely invisible. In this chapter, we will: i) define the term informal venture capital; ii) discuss some of the methodological challenges faced by researchers in this emerging area of study; iii) summarise the findings of studies undertaken to date which will provide an overview of the characteristics and behaviour of market participants, commonly referred to as business angels[1] or private investors; and, in doing so iv) highlight the "knowledge gaps" which still exist.

2.1 An Overview

While the documented existence of the informal venture capital market dates back to at least the pioneering days of Henry Ford, the economic significance of this market has only comparatively recently been appreciated. The informal venture capital market is comprised of private individuals who invest their own risk capital into new and growing businesses in which they have no prior connection (Mason and Harrison 1992). Aside from providing capital, private investors are generally considered to be "value added" investors contributing know-how based on extensive, prior management and new venture development experience. (Wetzel 1983). The role of private investors is neatly described by one author as "...informality served up with the kind of critical business

[1]The term was coined to describe benefactors of means who supported theatrical productions on Broadway. To producers constantly in search of capital, these individuals were viewed as "angels from heaven". In this study, we shall use the term "private investors" in place of "business angels" as the latter creates an impression that an investor is essentially a philanthropist, a conclusion which research will show is not necessarily the case.

judgement so important to a fledgling entrepreneur" (Conlin 1989, 36). Private investors provide the entrepreneur "... with the benefits of their know-how - most of which they acquired making their own mistakes in business, the way entrepreneurs learn their most valuable lessons" (Wetzel 1994, 180).

The importance of the informal venture capital market becomes readily apparent when one examines both the nature of investments made by private investors and the scale of their activity. It has long been recognised that a major constraint to the formation and/or growth and development of small and medium sized firms ("SMEs") is access to adequate sums of capital on reasonable terms. The situation created by excess demand for, and inadequate supply of, capital was first highlighted in a report to the British Government[2] and came to be known as the "equity gap"[3]. More than sixty years after diagnosing the "equity gap" problem[4], Freear and Wetzel (1992) conclude that the perception of the ailment still exists, particularly for:

- technology-based inventors seeking product development finance;
- ventures in their early stages of development[5];

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[2]Macmillan Committee, 1931, *Report of the Committee on Finance and Industry*, Cmnd. 3897, London: HMSO.

[3]Riding and Short (1987b) distinguish between: i) "supply side gaps" caused by real shortages of capital; ii) "demand side gaps" resulting from arbitrary restrictions imposed by the entrepreneur for personal reasons, such as the need to retain equity control or an unwillingness to consider relinquishing equity stakes to outside investors; and iii) "expectation gaps" arising because the investor and entrepreneur are unable to reach an agreement on the terms of an "equitable" financing arrangement.

[4]The equity gap problem was also highlighted in two subsequent reports commissioned by the British Government in the 1970's: i) the *Report of the Committee of Inquiry on Small Firms* (Bolton Report, 1971), and ii) the *Interim Report on the Financing of Small Firms* (Wilson Report, 1979). Sohl (1999) makes reference to a "capital gap" both in terms of the demand for equity capital exceeding available supply, estimated at 2:1.

[5]A number of different classification schemes are used for defining stages of venture development. Unless otherwise indicated, we will adopt the classification scheme developed by the British and European Venture Capital Associations.

Seed	Financing provided often *prior to incorporation* to research, develop and assess an initial concept before a business has reached the start-up stage .
Start-up	Financing provided to companies for product development and initial marketing. Companies may be in the process of being set up or may have been in business

- ventures with small capital requirements (less than $500,000); and
- closely-held firms unable to finance growth from internally generated cash flow.

A growing body of research evidence (Baccher and Guild 1996; BVCA 1997a; Mason and Harrison 1994b, 1994c; Mason, Harrison and Chaloner 1991; Freear and Wetzel 1988, 1989, 1990; Freear, Sohl and Wetzel 1991, 1995; Suomi and Lumme 1994; Wetzel 1981, 1987, Benjamin and Margulis 1996; Coveney and Moore 1998; Sohl 1999) suggests that private investors invest specifically in those situations where the perceived "equity gap" is greatest - high risk, early stage ventures - and that, in terms of the scale of their activities, private investors are the largest single source of risk capital in both the US and UK (see Gaston 1989b; Wetzel 1987; Benjamin and Margulis 1996; Harrison and Mason 1993; Coveney and Moore 1998; Sohl 1999). The rationale for learning as much as possible about the underlying dynamics of this market is compelling, so much so that one report[6] concluded that "there is a clear need ... for the ready availability of smaller amounts of risk capital" (ACOST 1990, 35) and that "...an active informal venture capital market is a pre-requisite for a vigorous enterprise economy" (ACOST 1990, 41).

Accepting for the moment that: i) the informal venture capital market performs a very important role in bridging the "equity gap" faced by SMEs; and ii) the phenomenon is not new, two questions immediately come to mind. First, why did it take so long for researchers to focus their attention on

	for a short time, but have not sold their product or service commercially.
Early Stage	Financing provided to companies that have completed the product development stage and require further funds to initiate commercial manufacturing and sales. They may not yet be generating a profit.
Expansion	Capital provided for the growth and expansion of an established company that is breaking even or trading profitably. Funds may be used to finance increased production capacity, market or product development and/or provide additional working capital. Capital provided for turn-around situations is also included in this category, as is bank debt refinancing.
MBO	Funds provided to enable *current* operating management and investors to acquire an existing product line or business.
MBI	Funds provided to enable a manager or group of managers from *outside the company* to buy into the company.

[6] *The Enterprise Challenge Overcoming Barriers to Growth in Small Firms*, 1990, Advisory Council on Science and Technology, London: HMSO.

this important phenomenon? After all, the pioneering work of Wetzel in this field only first appeared in 1981 and in many respects researchers are still trying to establish "... some boundaries on our ignorance" (Wetzel 1986, 132). Second, what do we know about the dynamics of the informal venture capital market? In short, what is the state of knowledge of the informal venture capital field?

In response to the first question, researchers face a number of interesting challenges as: "The (informal venture capital) market is a virtually invisible and demonstrably inefficient segment of the total market for capital. There are no directories of individual investors, no public records of their investment transactions, and few vehicles by which potential investors and ventures seeking funds may be brought together" (Freear and Wetzel 1992, 462).[7] An underlying reason for the persistence of market inefficiencies is the desire of investors to remain anonymous, primarily as a means of controlling the volume of their deal flow. The market has been aptly described "...as a giant game of hide-and-seek with everyone blindfolded" (Gaston 1989a, 4). How have researchers attempted to make the "invisible visible"? It is to this issue that we now turn.

2.2 Methodological Considerations

Understandably, private investors prefer a degree of anonymity both as a means of controlling the volume of their "deal flow" and of protecting sensitive information pertaining to their private investment activity. As a result of this invisible character of the informal capital market, Wetzel (1983) concludes that the size and characteristics of the informal venture capital market is "unknown and probably unknowable". As a result, it is not possible to assess the representativeness of any sample in the absence of complete information about the population from which the sample is drawn.

[7] The research activities of Harrison and Mason have been instrumental in the development of business introduction services in the UK to facilitate the search process for both investors and entrepreneurs. Sohl (1999) has also noted the emergence of angel alliances that band together the capital and skills of numerous private investors, many of whom establish visible "store fronts" that facilitates the search process for entrepreneurs while respecting the identity of its members.

Researchers in the field have responded to the challenge of identifying private investors in a number of ways[8]. First, working on the assumption that private investors have higher levels of discretionary income, sample frames have been developed to undertake large-scale postal surveys often with information provided from purchased mailing lists. For example, lists of professionals (doctors, dentists, accountants, lawyers), executives, business school alumni, luxury car owners, business magazine subscribers, and the like are compiled and a sample of private investors is distilled from the list of potential candidates. In essence, researchers cast a wide net to capture "a few fish"; a necessarily expensive proposition in view of the low response rates achieved, often under 5%. In addition, biases are introduced any time investor characteristics are described ex ante in the absence of any information on the population. Moreover, the possibility exists that relatively more active and successful investors are predisposed to respond to surveys (Haar, Starr and MacMillan 1988) thus introducing unknown biases into any subsequent analysis of the results.

A number of studies have attempted to contact investors through the firms in which they have invested. While it is possible to develop estimates of market scale using this approach (Gaston 1989b), response rates have been very low[9]. Response rates are depressed by the combination of two key factors: i) the proportion of firms which have raised capital from private investors is relatively small; and ii) investors expressing an initial willingness to participate in a survey but failing to do so.

A third approach, which becomes feasible once an initial sample of private investors is identified, is to employ what has been described as a nominated or "snowball" sampling technique relying on private investors themselves to identify other investors. This research strategy exploits the fact that many private investors rely on a close network of friends and business associates to identify suitable investment proposals *and* often invest as part of a syndicate of investors. To provide some indication of the "leverage effect" of this strategy, Neiswander (1985) identified six private investors who, in

[8]For a detailed discussion see Mason, Harrison and Chaloner (1991).

[9]Gaston and Bell (1986, 1988) obtained 435 usable responses from 240,000 firms (0.2%). Aram (1987) similarly reported 55 usable surveys from a sample of 20,000 firms (0.3%).

turn, provided referrals to 113 additional investors. Similarly, in the UK, fifty-three private investors surveyed by 3i Group (1994) reported knowing 180 friends who were also private investors. Again, however, unknown biases are introduced insofar as investors may associate with other like-minded individuals.

Despite the challenges faced in trying to locate and accurately identify every element of the population, researchers have made measurable progress on a number of fronts to enhance our understanding of how this "giant game of hide-and-seek", better known as the informal venture capital market, is played. What have we learned about this market? It is to this question that we now turn.

2.3 Market Scale

"Although precise estimates are not available, evidence from research conducted in the US and UK suggests that the informal venture capital market is the largest single source of risk capital for entrepreneurial companies" (Harrison and Mason 1993, 18). It would seem that Gaston (1989b) had every right to describe the market as "giant" as data from the US and UK clearly demonstrate.

United States

Based on data collected in three surveys of private investors sponsored by the US Small Business Administration ("SBA") (Gaston and Bell 1986; Aram 1987; Gaston and Bell 1988), Gaston was able to develop estimates of market scale for the US using data from the SBA's Dun's Market Identifier file (Gaston 1989b). He estimated that in 1984, more than 720,000 private investors made 490,000 investments providing a total of $32.7 billion in equity and $23 billion in debt financing to some 87,000 firms (an average total investment per firm of $400,000). The amount of equity invested in private firms was fully eight times larger than the total commitments made by the US venture capital industry in 1984. Moreover, in excess of $19 billion of additional funds was available for further investment and remained uncommitted; a reflection, perhaps, of one of the key inefficiencies of this market, namely the difficulty of bringing together investor and entrepreneur in an efficient and effective way. Taking committed and uncommitted funds together, private investors had available a pool of approximately $75 billion to invest in 1984.

Using data obtained from the 1983 Survey of Consumer Finance, Ou (1987) estimated that two million families in the US held investments totalling some $300 billion in privately-held businesses in which they have no *management* involvement. The amount invested is fully fifteen times higher than the portfolios of all US venture capital funds in 1983. Two caveats should be noted. First, the estimate provided *includes* investments in businesses in which a family connection exists; our definition of informal venture capital excludes such investments, thus, it is reasonable to conclude that the estimate provided is overstated by an unknown magnitude. Similarly, Ou's estimate *excludes* investments where an investor *is* involved in management. Received research indicates that a substantial minority of private investors do assume management positions in investee companies (Wetzel 1981; Tymes and Krasner 1983; Gaston 1989a; Freear, Sohl and Wetzel 1990; Venture Economics 1990; Mason, Harrison and Chaloner 1991; Mason, Harrison and Allen 1995; Landström 1993), hence, Ou's estimate may in fact be also understated to an unknown degree.

The Centre for Venture Research based at the University of New Hampshire has estimated that there are two million *potential* private investors in the US, defined by them as individuals with personal net worth (excluding personal residences) in excess of $1 million. Of this total, 250,000 private investors are active in any given year investing approximately $10 billion per year in 30,000 ventures, committing fully five times as much capital to ten times as many ventures as do venture capitalists (Maruca 1993). Based on their experience building an active network of private investors in Silicon Valley, Benjamin and Margulis (1996) estimate that there are 150,000 to 250,000 active private investors in the US with a pool of $20 billion in capital to invest.

While the estimates provided vary, it can reasonably be concluded that "...conservatively, the informal venture capital market (in the US) is made up of several hundred thousand high net worth individuals, most with business and entrepreneurial experience, who invest at least $10 to $20 billion in over 30,000 ventures per year" (Freear, Sohl and Wetzel 1994a: 8).

United Kingdom

In the UK, it has been estimated that SMEs have raised approximately £2 billion from the informal venture capital market (Harrison and Mason 1993; Mason and Harrison 1994c), roughly double the £1.25 billion invested in SMEs by venture capitalists (Bannock 1991). More recent research has estimated the total amount invested by private investors at £5 billion, almost four times as much capital into thirty to forty times more small entrepreneurial firms than venture capitalists (van Osnabrugge 1998b). Similar to the situation in the US, the scale of the UK market is underestimated insofar as many private investors are constrained not by a lack of discretionary investment funds but, rather, by an insufficient supply of suitable investment proposals (Coveney and Moore 1998).

2.4 Investor Profiles

What do we know of the population of private investors? Are there any distinguishing characteristics? Table 2.1 provides a comparative summary of findings for research conducted in the US, Canada, UK, Sweden and Finland. In comparing the results of these six surveys, one is struck by the similarity of the characteristics of a "typical" private investor across the five countries studied. The emerging consensus of a "typical" investor appears to be:

- a middle aged male; with
- reasonable net income and net worth; and
- previous start-up experience; who
- makes one investment a year, usually close to home; and

- prefers to invest in high technology and manufacturing ventures; with
- an expectation to sell out in 3 to 5 years time.

While it is appealing to conclude that private investors as a group across a number of countries share similar traits, the evidence collected to date supports the notion that the informal investment market is rather heterogeneous in character (Wetzel 1994). Postma and Sullivan (1990) were able to distinguish three distinct groups of private investors based on their motivation for investment - financial, altruistic or self-oriented. A number of authors have developed classification schemes to distinguish various "types" of private investors including Gaston (1989b)[10], Benjamin and Margulis (1996)[11] and research along a similar line conducted in the UK (Coveney and Moore 1998) identified five distinct types of investors[12]. Based on interviews with over 700 US private investors, Benjamin

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[10]i) *"Devils"*- Angels who gain control of the company; ii) *"Godfathers"*- Successful, semi-retired, consultants/mentors; iii) "*Peers*"- Active business owners helping new entrepreneurs, with vested interest in the market, industry or individual entrepreneur; iv) "*Cousin Randy*"- A family-only investor; v) "*Dr Kildare*"- Professionals such as MDs, CPAs, lawyers and others; vi) "*Corporate Achievers*"- Business professionals with some success in large corporate organisations but who want to be more entrepreneurial and in top-management roles; vii) "*Daddy Warbucks*"- The minority of business angels who are as rich as all angels are commonly - and incorrectly - believed to be; viii) "*High-Tech Angels*"- Investors who invest only in firms manufacturing high-technology products; ix) "*The Stockholder*"- An angel who does not participate in the firm's operations; and x) *"Very Hungry Angels"*- Angels who want to invest over 100 percent more than deal flow permits.

Gaston (1989b), p. 10

[11] i) "*Value-Added Investors*" - Very experienced individuals who invest in syndicates and want to be actively involved in the venture development process; ii) *"Deep-Pocketed Investors"* - Individuals who have built and sold a business of their own, have corporate experience, seek control and some level of involvement with the venture; iii) "*Consortium of Individual Investors*" - Individuals who have built new ventures, prefer passive involvement with the business and who invest as a group in a wide variety of different proposals including early stage ventures; iv) "*Partner Investors*" - A buyer in disguise who has high needs for control, wants an executive position but lacks the funds to buy out a business outright; v) "*Family of Investors*" - Represents a pool of funds supplied by family members, astutely managed and desirous of being intensely involved over short periods of time; vi) "*Barter Investors*" - Focus on early-stage growth businesses providing needed resources to support growth in exchange for equity; vii) "*Socially Responsible Investors*" - Seek intense interaction with ventures that "share a common cause"; viii) "*Unaccredited Investors*" - Less experienced, less affluent individuals who invest small amounts of capital in a diversified manner; and ix) "*Manager Investors*" - Individuals who have a low tolerance for risk and want to buy into a challenging job by making one personally significant investment in a venture in which they are very actively involved.

[12]i) "*Virgin Angels*"- Individuals with funds available who are looking to make their first investment; ii) *"Latent Angels"*- Rich individuals who have made angel investments, but not in the past 3 years; iii) "*Wealth Maximising Angels*"- Rich individuals and experienced businessmen who

and Margulis (1996) also developed a broadly inclusive classification scheme. A small number of studies have also begun to focus on the most active segment of market participants, so called "serial investors", who have completed at least three private investments to date (Kelly and Hay 1996b, 1996c, van Osnabrugge 1998a). Heterogeneity poses a particular challenge for policy makers attempting to identify means of enhancing market efficiency[13] and expanding market scale[14], namely that generic policy prescriptions may not address the needs of all elements of the target population equally effectively.

Having said this, one particularly important characteristic which consistently emerges in a number of studies across different countries (Wetzel 1981; Sullivan 1991; Neiswander 1985; Short and Riding 1989; Riding 1993; Mason, Harrison and Chaloner 1991; Coveney and Moore 1998; 3i 1994; Landström 1993; Suomi and Lumme 1994; van Osnabrugge 1998b) is that private investors are remarkably entrepreneurial individuals in their own right. It seems reasonable to suggest that entrepreneurs, particularly those with limited or no previous new venture experience, stand to benefit greatly from the accumulated experience of an investor that has lived through the process of developing a new venture before.

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invest in several businesses for financial gain; iv) *"Entrepreneur Angels"*- Very rich, very entrepreneurial individuals who back a number of businesses for both the fun of it and as a better option than the stock market; and v) *"Income Seeking Angels"*- Less affluent individuals who invest some funds in a business to generate an income or even a job for themselves.

[13]From the viewpoint of investors, however, imperfect markets create the conditions for earning abnormally high returns on investment. The prospect of being able to uniquely identify and potentially profit from these market imperfections may be regarded as a key incentive for private investors to assume the inherently high risks of investing in early stage ventures in the first place. In the absence of potentially high rewards, some investments simply would not be made.

[14]Market scale can be expanded in a number of ways by encouraging: i) active market participants to invest more; ii) inactive participants to make their first investment; and iii) entrepreneurs to seek out this form of equity finance.

Sources of Investment Opportunities

Friends and business associates are the dominant sources of investment opportunities as evidenced by the data reported in Table 2.1. In New England, business associates and friends were an equally important source of prospective investments; 60% of those surveyed were informed of opportunities through these sources. Almost half the private investors identified prospective investment opportunities as a result of active personal search (Wetzel 1981). Krasner and Tymes (1983) replicated Wetzel's (1981) study in California and reported similar findings although the investors they surveyed were rather less inclined to rely on active personal searches and, on the whole, were more satisfied with referral sources. Of those respondents expressing an opinion, 70% indicated they were satisfied to varying degrees as compared to a majority of respondents (65%) in the New England survey who reported varying levels of dissatisfaction with referral sources. Evidence from Canada (Riding, Duxbury and Haines 1994) reaffirms the importance of business associates and friends as referral sources. Almost half the investors surveyed relied quite often on active personal searches to identify potential investment opportunities.

Haar, Starr and MacMillan (1988) found support for the notion that friends, business associates and investor colleagues were the most important referral sources. Their findings also supported the notion that the investor was more inclined to invest if a referral was made by a close personal, as opposed to a professional, contact. Based on actual investments made over a five year period by Tennessee-based private investors (Postma and Sullivan 1990), in nearly three-quarters of the cases the deal was referred to the investor by a close friend or family member (49%) or by a business associate (24%). Freear, Sohl and Wetzel (1994a) empirically tested the notion of referral "efficiency"; efficiency measured as the proportion of investments actually made to the number of opportunities presented by a specific referral source. Business associates and friends were the two most important referral sources; moreover, in their analysis of 525 investments made by 150 private investors during the period 1987-1991, private investors actually invested in more than half of the opportunities referred to them by friends and in almost 30% of the proposals referred to them by business associates.

Sohl (1999) believes that a substantial proportion of investment opportunities are channelled through to potential investors by gatekeepers, such as accountants, lawyers and venture capitalists, in what he termed the "uncover market". Moreover, he noted that with the emergence of greater numbers of venture capital clubs and angel alliances that bring together numerous private investors to participate in deals, potential opportunities are increasingly being referred to the group from investors themselves.

Private investors were asked in one UK study to identify the source(s) of information concerning potential investment opportunities. Business associates were cited most often (60%), followed by friends (49%), and accountants (28%); active personal search was used by more than one-quarter of the private investors surveyed (Mason & Harrison 1994c). Almost half of the respondents were, to some extent, dissatisfied with their existing referral sources (Harrison and Mason 1992a). Similarly, personal and business contacts were the top two referral sources identified by the investors surveyed by 3i (1994).

Evidence from Sweden (Landström 1993) confirms the importance of business associates and friends as referral sources, however, compared to their US or UK counterparts, Swedish private investors tend to rely, to a much greater degree, on active personal searches for identifying investment leads. The most frequent source of investment opportunities for Finnish private investors was business contacts and friends, however, investors considered venture capitalists to be the best source of "quality" information (Suomi and Lumme 1994).

In the absence of any formally organised market or investor directories, it is not surprising to see that private investors respond to market inefficiencies by relying, to a great extent, on referrals from trustworthy sources known to them personally or by other interested investors known to them. The high levels of dissatisfaction reported with existing referral sources may, in fact, be symptomatic of the inherent inefficiency of this "informal" approach to developing a reasonable flow of credible investment proposals. Freear, Sohl and Wetzel (1994a) conclude that limited efficiencies may indeed be operating within a close, highly localised network of trusted friends and business associates; the challenge becomes one of how to facilitate the efficient and effective transfer of information among a larger audience and over a wider area[15].

Rate of Return Expectations

An investor bears risks any time an investment is made in any venture, be it public or private, large multinational or small firm. In many instances, private investors choose to invest in situations in which the risks assumed are quite high indeed; ventures in their formative stages of development with a limited, if any, track record of performance. For the most part, shares in privately-held firms are highly illiquid and notoriously difficult to value, hence inherently high business risk is compounded by high liquidity risk. For assuming these higher risks, finance theory would suggest that private investors should seek higher expected returns. Moreover, theory would suggest that rational investors can be expected to have a positive utility for wealth; they prefer more wealth to less and act in a manner consistent with the principle of wealth maximisation. To some extent, the available evidence would suggest that private investors do behave in a manner that theory would prescribe[16].

As a matter of course, private investors do generally seek investments that offer the possibility of realising substantial gains on capital invested. Haar, Starr and MacMillan (1988) reported that more

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[15]Another line of reasoning would suggest that inefficient and imperfect markets are a necessary prerequisite for an investor to achieve abnormally high returns on investment. Market invisibility creates problems for private investors finding promising ventures to back and vice versa, however, once a promising opportunity is identified there is a good likelihood that there will be little competition for the deal. Contrast this situation with the state of the highly visible and competitive market for MBO/MBI financing in the UK. Anecdotal evidence would suggest that returns achieved by UK venture capitalists on these types of transactions are depressed due to intense competition for these deals among market participants.

[16]In a survey of 214 Tennessee business angels, Sullivan and Miller (1990) found support for the hypothesis that a positive correlation exists between the perceived level of risk and expected return of an informal investment.

than half of the 121 private investors surveyed on the US East Coast expected to multiply their investments by a factor of one to four times, 10% of respondents expected a return in excess of ten times capital invested. In a survey of 210 Knoxville Tennessee-based informal investors, 61% of respondents rated "potential for high capital appreciation" as the most important reason for investing; in excess of 90% considered it to be one of the top two motivating factors (Sullivan 1994). Over 90% of the 86 UK private investors surveyed by Mason and Harrison (1994c) considered the possibility of high capital appreciation to be a very/quite important reason for investing. In another survey of UK private investors, almost 45% of the active, individual investors were classified as "wealth maximising", motivated, in large measure, by financial considerations (Coveney and Moore 1998).

Not surprisingly, the more established the venture, the lower the required rate of return *ceteris paribus*. Annual compounded rates of return on investment ranged from 22.5% for established ventures (over five years old) to 50% for technology-based inventors (seed stage) in New England (Wetzel 1981) - comparable figures for California (Tymes and Krasner 1983) were 34% and 100% respectively. Considered another way, New England investors were looking for five year capital gains of between three and ten times invested capital as compared to a range of five to thirty-one times invested capital for California-based private investors. Canadian private investors anticipate, on average, realising a seven-fold after tax return on invested capital over a seven year period; which translates into an annual compounded return on investment of 32% (Riding 1993).

A similar pattern to the US and Canada is evident in the UK. Investors surveyed by Mason Harrison and Chaloner (1991), required, on average, an annual rate of return of 31% on their investments; ranging from a median 21% for established to 45% for seed stage ventures. On average, UK private investors expected a five fold capital gain on invested capital over an unspecified holding period. Van Osnabrugge (1998a) noted that serial investors, individuals who had completed more than three investments, expected to realise a return of 33% on their investments, almost 50% higher than non-serial investors. On average, Swedish informal investors required an annual rate of return of 15% on their portfolios, somewhat lower than their UK and US counterparts. This is not altogether surprising given the relatively stronger preference Swedish investors exhibit for later stage, and thereby, lower risk deals.

Non Financial Motivations ("Psychic Hot Buttons")

However, in some respects, private investors do not always behave in a manner strictly based on a positive utility for wealth. Research has confirmed that informal investors are also motivated by a variety of non-financial factors, so called "hot buttons" or "psychic income" (Wetzel 1981), demonstrating a willingness to trade-off financial for non-financial considerations. The notion of "hot buttons" was supported in a large scale Canadian study (Duxbury, Haines and Riding 1994) wherein one of the underlying motivations for investing was the need for an investor to be affiliated with a project that creates a new company and/or the excitement derived from being actively involved in venture development. Benjamin and Margulis (1996) also reinforce the notion that understanding and appealing to an individual's non-financial motivations for investment is a critical element of a successful "capitalisation strategy" as they describe the capital search process.

Over one-third of New England-based investors surveyed by Wetzel (1981) were prepared to accept a lower return on investment if a venture created jobs locally or developed socially useful technology. Almost half of the respondents were prepared to accept a median return reduction of 10% when an investment provided an "opportunity to assist an entrepreneur". Wetzel's study was replicated in California by Tymes and Krasner (1983). Similar effects were noted, however California-based private investors "...(would) accept considerably lower rates of return on such ventures than their New England counterparts" (Tymes and Krasner 1983, 363). Sullivan and Miller (1990) presented respondents with seven scenarios to determine whether an investor would be prepared to give up some portion of a 20% guaranteed return if an investment exhibited certain non-economic characteristics[17]. For all but one scenario, a majority of investors surveyed were prepared to give up,

[17]See also Sullivan (1994) for details.

on average, almost 4% in return if an investment (% of respondents prepared to trade off financial return): i) produces a socially beneficial product (83%); ii) presents an opportunity for the investor to become actively involved (66%); iii) creates jobs locally (65%); iv) is located nearby (63%); v) provides the opportunity to interact with highly regarded investors (61%); vi) promotes social ideals the investor supports (59%); and vii) is exciting in nature (47%).

Evidence from Mason and Harrison's UK survey (1994c) support the notion that non-financial factors are important considerations when making investments; 74% of respondents considered "playing a role in the entrepreneurial process" to be an important motivation, as well as "for the fun of investing" (60%), and "to support new business" (47%). A large majority (63%) of the investors surveyed by van Osnabrugge (1998b) considered their ability to address management gaps in the venture to be an important motivation for investing in the first place.

Investment Criteria

Time and again, when asked to identify the principal criteria used to evaluate investment proposals, private investors consistently stress the importance placed on: i) the quality of the entrepreneur or management team; and ii) the market growth potential for the product or service (Baccher and Guild 1996; Benjamin and Margulis 1996; Harrison and Mason 1992a; Mason and Harrison 1994c; Haar, Starr and MacMillan 1988; van Osnabrugge 1998b). Of the two, the calibre of the founding entrepreneur/team seems to be a paramount concern (van Osnabrugge 1998b). In a large scale study of UK private investors (Coveney and Moore 1998), 59% of those surveyed considered their impression of the founder/management team to be the principal investment criteria. Considered another way, when asked to identify reasons for rejecting a proposal, so called "deal killers", members of an investment syndicate surveyed reported that factors related to the management team were cited in fully one-third of the proposals rejected followed closely by factors related to the market or the financial viability of the proposal (Mason & Harrison 1994a). In over 80% of the cases when a deal was rejected, Canadian private investors cited lack of confidence in management as a contributing factor in the decision not to invest (Riding and Short 1987b; Riding 1995).

In a comparative study of investment behaviour, Fiet (1991, 1995a, 1995b) concluded that private investors tended to view agency risk - the extent to which entrepreneurs and investors hold differing and possibly divergent interests - as more important than did venture capitalists. Moreover, private investors tended to rely on themselves rather than on friends, business associates or venture capitalists, to gather agency risk information to assess the character and integrity of the entrepreneur (Fiet 1991, 1995a, 1995b). In comparison, venture capitalists tended to view the market risk associated with an investment - competitive dynamics which can impact the size, growth rate, accessibility and the level of market demand - to be a more important consideration than did private investors and they relied on their network of relations with other venture capital firms to gather information to assess market risk. Van Osnabrugge (1998a) did, however report some support for the notion that particularly active private investors tend to focus their attention relatively more on market (understanding the industry) as opposed to agency (assessing the people) risk.

Decision-Making Process

Relatively little work has been done which examines private investor investment behaviour from a process perspective. The findings of one study (Riding, Duxbury and Haines 1994) which surveyed 279 private investors in Canada concluded that they generally follow a sequential decision process. Typically ninety percent of all investment opportunities presented to investors were rejected after a cursory glance of the business plan. In this early stage, private investors form an overall impression of a proposal based on a number of criteria including prospective financial return, management capability and the feasibility of the concept itself. It is noteworthy that investment opportunities referred to an investor by a business associate stood a better chance of passing an initial screen insofar as a trusted referral source might in fact be a preliminary filter for the "adverse selection problem"; namely, the decision of whether to invest and on what terms in the face of information asymmetries between potential investor and entrepreneur.

As the decision process unfolds, the importance of the "management capability factor" increases in importance in the early stages of due diligence. Once due diligence is completed - and the authors suggest that private investors employ a "less formal" approach to due diligence than venture capitalists in view of cost constraints - the decision to invest rests mainly on two factors: prospective financial return and the personal "chemistry" between investor and entrepreneur. In the final analysis, private investors in this study invested in only three proposals for every one hundred opportunities presented.

Mason and Rogers (1996) reached broadly similar conclusions as Riding, Duxbury and Haines (1994) in their study of UK private investors. Respondents were presented with a number of potential investment opportunities for their consideration. Using verbal protocol techniques, investors were asked to describe their thoughts "out loud" as they were forming an opinion about the proposal in question. The most significant extension of the project examined the role of trust in the decision-making process of the investor (Harrison, Dibben and Mason 1997). Faced with time pressures and often a limited base of previous experience working with the entrepreneur, investors must make inferences about the trustworthiness of the counterparty, so called swift trust. In the very early screening stage of the decision-making process, they noted that investors look for reasons to reject a proposal as a means for focussing their time, energy and resources on opportunities that offer the greatest potential benefits, economic and otherwise. In large measure, this assessment is made both on the basis of the investor's previous base of experience evaluating deals and the perceived level of competence of the management team.

In the UK, van Osnabrugge (1998b) has published a comparative study of the approaches adopted by private investors versus venture capitalists with respect to investing in privately-held companies. While both are broadly interested in investment opportunities that offer strong growth potential and are driven by capable individuals, notable differences between the groups was reported. Compared to private investors, venture capitalists claimed to have significantly more experience in the industry sectors in which they invest and undertake more detailed research on these sectors prior to investing. Private investors met the entrepreneur on average five times prior to investing (ten for venture capitalists), took fewer references, focused less on expected financial returns, and spent on-third less time completing the transaction (15 weeks) than venture capitalists. Understanding the process of raising informal venture capital has also been highlighted with the publication of books targeted at practitioners (Benjamin and Margulis 1996; Coveney and Moore 1998) and guides for investors and entrepreneurs (NatWest 1998).

In Sweden, Landström (1995) identified two distinct strategies used by private investors to aid them in making investment decisions. Specialist investors choose to limit their activity in areas related to their particular market and/or technical expertise. Compared to investors that sought portfolio diversification in terms of industry and/or stage of venture development, specialists examined fewer proposals and exhibited a higher propensity to invest than explicitly diversified investors. Having said this, the two groups relied on similar criteria to evaluate opportunities.

2.5 Portfolio Characteristics

Investment Activity

As evidenced in Table 2.1, informal investors are typically both frequent (one investment per year on average) and relatively small (< $100,000 per investment) investors.

Remarkable consistency is demonstrated between countries in terms of the level of past investment activity. On average, private investors make almost one investment per year (see Table 2.1). However, there is a growing body of evidence to suggest that the distribution is in fact bimodal; characterised, on the one hand, by a large number of individuals who have not invested as yet (so called "virgin investors") or invest relatively infrequently, and, on the other hand, by a significant group of very active, often large scale, investors. Almost a third of the investors surveyed by Mason, Harrison and Chaloner (1991) did not make an investment in the previous three year period whereas

7% of the respondents reported making two or more investments every year over the same period. Almost half of the respondents in another UK survey (Coveney and Moore 1998) classified themselves as "virgin investors" or "latent investors" (have made previous investments but not in the preceding three year period). A similar pattern is evident in Sweden where 30% of private investors reported making one or no investment in the past three years while in excess of one third of respondents reported completing four or more investments during the same period (Landström 1993).

Similar to investment activity, the distribution of average investment size is also bimodal in nature.18 In general, there is a very large group of investors who prefer to invest smaller amounts of capital into deals and a small, yet in terms of overall scale, very significant, group of investors who display a tendency to make larger capital infusions. In the US, a substantial percentage of private investors - ranging from 37% (Neiswander 1985) to 78% (Wetzel 1981) - prefer to make investments of less than $50,000 in any given venture. A significant number of investors - from 12% (Wetzel 1981) to 33% (Neiswander 1985) of respondents - prefer rather larger deals, in excess of $100,000 on average. In a study of actual investments made over a five year period by 215 private investors in Tennessee (Postma and Sullivan 1990), almost half of the investments made were less than $25,000 and fully 20% of the deals were in excess of $100,000.

Two-thirds of the investments made by Canadian private investors during the period 1988-1992 involved capital infusions of less than $100,000 whereas 15% of the deals reported were in excess of $250,000 (Riding 1993). Evidence from the UK also supports the notion of a bimodal distribution. Over half of the respondents in one survey (Mason, Harrison and Chaloner 1991) had invested less than £25,000 in total in the preceding three year period; 20% of the private investors reported investing more than £100,000 over the same period. Based on an analysis of 176 investments made over a one year period by 333 private investors, almost 70% of the respondents had committed less than £50,000 to a single investment, however, one in seven respondents had invested more than £100,000 in a single deal (BVCA 1997a). In another study (3i 1984), 38% of respondents had

[18] An observation supported by Benjamin and Margulis (1996).

informal investment portfolios totalling less than £25,000 as compared to 34% who reported portfolios valued (at cost) in excess of £100,000. Landström's survey (1993) of Swedish investors also displays a bimodal distribution of investments made; 35% of respondents had invested less than $182,000 and 10% reported making more than $1.8 million in investments in the preceding three year period.

Expected Investment Activity

Of somewhat greater significance to entrepreneurs seeking capital and to policy makers alike is the anticipated future rate of investment. Earlier, in discussing the scale of informal venture capital markets in the US and UK, mention was briefly made of the excess supply of funds available in the market. In large measure, this situation is caused by the inherent difficulties encountered by entrepreneurs in trying to locate potential private investors and vice versa.

It should not be surprising to discover that private investors in all of the countries studied have a latent demand for additional deal flow. Almost 90% of New England investors expected to add between one and three investments in the subsequent two year period (Wetzel 1981). Private investors in California, expected to add, on average, ten new investments to their portfolios in two years' time (Tymes and Krasner 1983).

The evidence in the UK also supports the notion of latent private investor demand for suitable investment proposals. Fully 70% of private investors in one survey (Mason, Harrison and Chaloner 1991) expressed an interest in making more investments, but were hindered by the lack of suitable opportunities brought to their attention. Over three quarters of the respondents in another study expected to increase the level of their investments within the next five years and almost half reported having in excess of £100,000 available for further investment (Coveney and Moore 1998). The "typical" private investor in the 3i study would like to triple the size of their portfolio from one to three investments and had, on average, £50,000 of additional capital to commit. Data from Sweden also supports the notion of "latent demand"; like their UK colleagues, three-quarters of investors wanted to make more investments but could not find suitable proposals in which to invest their funds (Landström 1993).

If inefficiencies in the informal venture capital market can be overcome, the supply of funds to entrepreneurial ventures should greatly increase as a result of two factors: i) with a greater flow of credible deals brought to their attention, active private investors will probably increase their investment activity, and ii) by facilitating information flows virgin investors may be encouraged to make their first investment, thereby increasing both the supply of investment capital available and the number of active private investors generally.

Venture Stage of Development Preferences

Private investors clearly demonstrate a propensity for investing in earlier stages of venture development. One third of the respondents in one study (Wetzel 1981) expressed a strong interest in investing in seed stage ventures and more than 40% reported similar desires with respect to providing finance to start-ups and infant (less than one year old) ventures. In a large scale study of 177 technology-based firms founded in New England between 1975 and 1986 which raised external equity capital, private investors accounted for 54% of the total amount raised and 60% of the financing rounds for seed and start-up stage investments. By comparison, venture capitalists invested 20% of the total amount raised and participated in 28% of the rounds for seed and start-up proposals (Freear and Wetzel 1988, 1990). Over 80% of the investments made over a five year period by private investors in the Postma and Sullivan study (1990) were consummated within two years of start-up.

Evidence from Europe provides somewhat mixed results. In one UK Study (BVCA 1997a), almost half of the investments (47%) made by 333 private investors over a twelve month period were early stage[19]. Proportionately the amount invested in earlier stage deals was somewhat smaller (43%) albeit approximately £7 million was committed to these ventures by private investors. In contrast, only 17% of the investments made by private investors in the 3i study (1994) were to start-up ventures as compared to 40% for MBOs/ MBIs. The findings in the latter instance may be biased insofar as 3i - the world's largest venture capital firm - often invested alongside the private investor; the later stage focus should not be surprising in view of the greater emphasis placed on these types of investments by venture capitalists[20] and the larger average size of the investments made[21]. On balance, however, received research would support the view that private investors disproportionately invest in early stages of development as compared to venture capital funds (van Osnabrugge 1998b; Coveney and Moore 1998).

Swedish investors display a decidedly later stage bias; 27% of investments were made in seed or start-up stages, 43% in firms more than one but less than five years old and fully 30% in established firms more than five years old. By contrast, Finnish investors exhibit a much greater propensity than their European counterparts to invest early stage - only one-quarter of their investments were to well established ventures (Suomi and Lumme 1994). In general, however, European private investors tend to invest much later in the venture development phase than their American counterparts, however, it should be noted nonetheless that they do demonstrate a strong commitment to early

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[19]Interestingly, there was virtually no investment activity at the seed stage. It would appear that entrepreneurs may have to rely on their own personal resources or on their relatives to secure the necessary capital to advance a venture *beyond* the seed stage. Investing personal resources up front can effectively be viewed as a bonding cost of sorts for gaining credibility with potential investors in the early stages of venture development.

[20]According to the latest statistics available from the British Venture Capital Association (1999), seed and early stage investments represented 21% (241) of all companies backed by their members (1148). Expansion capital accounted for 51% of companies backed (587) and management buy-outs and buy-ins the remaining 28% (320).

A disproportionately smaller share of capital was invested at the seed and early stages of development (8%) as compared to expansion (36%) and more significantly in MBOs/MBIs (56%). In total, £288 million was invested at seed and early stages as compared to £1,36 million and £2,13 million in the expansion and MBO/MBI stages respectively.

[21]3i reported investing £20 million in 53 ventures alongside investments totalling £3 million by private investors. The average amount invested per venture is in excess of £430,000.

stage equity financing as compared to venture capitalists.

Industrial Sector Preferences

Private investors in the United States (Wetzel 1981; Tymes and Krasner 1983; Aram 1989) and Canada (Riding and Short 1987b, Riding 1993) demonstrate a clear preference for investing in high technology manufacturing ventures. In contrast, Gaston and Bell (1988) did not find a strong preference for high technology investments among investors in the US Sunbelt region. Similarly, only one in five investments made by Tennessee private investors could be considered "high tech" (Postma and Sullivan 1990). In this respect, the work of Wetzel (1981), Tymes and Krasner (1983), Riding and Short (1987b), and Riding (1993) may, in fact, be a product of their geographical contexts drawing their samples from fertile areas of innovative activity - New England, California and the Ottawa-Carleton region, respectively.

In comparison to their North American counterparts, European investors are more inclined to invest in a number of different sectors. UK investors expressed sectoral preferences in manufacturing (half of which were high-tech in nature) and, to a somewhat lesser extent, service businesses (Mason, Harrison and Chaloner 1991). When actual investment activity is analysed, as opposed to stated industry preferences, UK private investors did display a great deal of diversity in terms of the types of opportunities they backed (BVCA 1997a), investing in roughly equal proportions in industrial and service based ventures. Based on his analysis of actual investments completed, van Osnabrugge (1998b) noted that in excess of 60% of the investments made were in high technology (24%), services (20%) or consumer manufacturing (19%) ventures. In another study, van Osnabrugge (1998a) also noted that particularly active investors tended to focus their investment activity into industry sectors in which they had prior experience. The situation in Sweden is somewhat unique insofar as investors surveyed did not express a strong interest in backing high-technology firms; preferences were demonstrated for ventures in the industrial manufacturing (31% of respondents) and finance/real estate (32% of respondents) sectors (Landström 1993). Again, Finnish investors displayed a strong preference for manufacturing ventures, particularly in high technology industrial sectors (Suomi and Lumme 1994).

Location Preferences

On balance, research findings to date support the notion that informal investments are highly "localised" in nature. A number of studies in the US (Wetzel 1981; Tymes and Krasner 1983; Aram 1989; Postma and Sullivan 1990; Freear, Sohl and Wetzel 1994a; Benjamin and Margulis 1996), Canada (Riding and Short 1987b, Riding 1993), UK (Mason, Harrison and Chaloner 1991), and Finland (Suomi and Lumme 1994) report strong investor preferences for ventures which are located less than fifty miles from the investor's home base. Coveney and Moore (1998) question the importance of location to UK private investors; in their survey, 58% of respondents thought that location was not important and 45% were prepared to consider proposals located more than 200 miles from their home base. Similarly, van Osnabrugge (1998a) noted that serial investors were less concerned about the location of their investments. It is important to note that both studies deal with statements of preference as opposed to actual investment activity; in the latter instance, on balance, empirical research supports a strong "localisation" effect.

A propensity to invest "close to home" may be a reasonable investor response to the inherent inefficiencies evident in the informal capital market (Sohl 1999). Investors are, in all likelihood, more aware of potential investment opportunities in their local area reliant as they are upon highly localised referral networks for creating deal flow. Moreover, research suggests that most private investors are active investors, providing on going "hands on" assistance in a number of capacities to investee companies (Benjamin and Margulis 1996). Sohl (1999) also highlighted the importance that investors place on being able to "kick the tires" when evaluating potential investment opportunities. Distance may thus create a substantial barrier both in terms of an investor's ability to undertake appropriate due diligence pre-investment or active involvement in the venture's development post-investment. This interpretation would support Wetzel's (1994) conclusion that the informal venture capital market may indeed be operating efficiently in "local pockets". Informal investors may desire to achieve a degree of geographical diversification in their portfolios, however, are unable to do so because of the difficulties faced in identifying suitable investment opportunities and local co-investors in distant markets.

2.6 Negotiating the Deal

For entrepreneurs seeking capital, the preparation of a business plan is a "necessary but not sufficient condition for raising finance" (Mason, Harrison and Allen 1995: 19). The plan itself should be written with the needs of the investor in mind, clearly articulating the vision, goals and objectives of the entrepreneur, the strategy to be used to achieve them, and the key risks associated with the investment (Wetzel 1994). While the business plan can provide the investor with key information to assess the opportunity and evaluate the game plan developed to exploit it, the assessment of management seems to be much more ad hoc and unscientific in nature. As mentioned previously, the quality of the management team is a paramount concern for informal investors; it would appear that investors tend to rely on an intuitive or "gut feel" approach to evaluate management capability (Mason, Harrison and Allen 1995). Van Osnabrugge (1999) also lends support for this notion that the "personal chemistry" between the parties is an important consideration in the investor's decision-making process.

It appears that very few entrepreneurs conduct systematic background checks on potential investors by speaking with their bankers, lawyers, accountants or other entrepreneurs that have raised capital from the investor. Knowing as much as possible about a potential investor is important as "(the entrepreneur) will be living with (the) investor through stressful times.... finding the right investor is worth the effort." (Wetzel 1994: 181). This sentiment is also echoed in a recent publication produced by NatWest Bank (1998).

In 70% of the deals examined by Mason, Harrison and Allen (1995), an investment agreement was drawn up. A minority of investors (38%) and entrepreneurs (44%) surveyed identified any difficult negotiating issues. In almost half of the cases where difficulties were reported, the problem areas identified related to pricing issues - the size of the equity stake relinquished. This is not altogether surprising in view of the problems associated with determining the value of an investment that often lacks public market referents, a demonstrated track record of performance, or a tangible asset base. Despite these difficulties, in two-thirds of the cases, both the investor and the entrepreneur felt that the final investment agreement was equally favourable to both parties.

Voting Control

In general, private investors do not seek voting control in the ventures in which they invest. In over 80% of the investments made in the past three years, California private investors maintained a minority equity stake (Tymes and Krasner 1983). Asked whether they would insist on voting control at the outset, slightly over 20% of the California investors surveyed responded positively (Tymes and Krasner 1983); the comparable figure for New England was 33% (Wetzel 1981). In almost 90% of the investments made by Canadian private investors between 1981 and 1986, the investor's equity stake was less than 25% (Riding and Short 1987b). This trend is also supported by the results of European research; less than 10% of UK (van Osnabrugge 1998b) and 15% of Swedish private investors surveyed (Landström 1993) had majority equity stakes in investee firms. Mason Harrison and Chaloner's (1991) study also reported that in fully half of the syndicated investments, the investor group held a majority stake. It seems reasonable to suggest that syndicated deals are often larger in size, as a result, the entrepreneur(s) will, of necessity, have to relinquish increasing levels of equity to raise larger amounts of equity.

Investment Style

Available US evidence clearly indicates that a majority of US private investors have invested alongside others or expressed a strong preference for participating in deals with co-investors. Over 80% of the respondents in two surveys (Wetzel 1981; Tymes and Krasner 1983) expressed a willingness to participate with other investors in a venture and over 90% of the 115 investments reviewed by Aram (1989) involved syndicates of investors, on average, 4.4 investors per deal. A preference for co-investing was also evident in Canada with all respondents save one expressing a willingness to co-invest alongside others. For those private investors that have invested as part of a syndicate of investors, in almost three times as many cases they invested alongside other private investors as opposed to a venture capitalist (Riding and Short 1987b; Riding 1993). Early research in the UK (Mason, Harrison and Chaloner 1991, BVCA 1997a) portrayed UK private investors as "lone wolfs" (Gaston 1989a) preferring to invest on their own. More recent research supports the view that UK private investors, particularly serial investors, prefer to participate in syndicates (van Osnabrugge 1998a) and have invested as part of a group of investors (Kelly and Hay 1996b, 1996c). The Swedish experience is quite similar to the US in this regard; over 80% of the investors surveyed had reported participating in a syndicated investment (Landström 1993). Finnish investors surveyed were more than likely to have done so as part of a syndicate, usually with other individuals (Suomi and Lumme 1994).

Participating as part of a syndicate would appear to offer a number of advantages to investors: i) the ability to participate in larger investments that could not be underwritten alone; ii) benefits arising from bringing together a more diverse set of investor skills and experience to bear on a venture; iii) the opportunity to expand a network of contacts as a source of further investment leads; and iv) the ability to participate in more deals (Sohl 1999). Syndicated deals do mean, however, that an individual investor must be willing to accept a lower relative equity stake in the venture, and it seems reasonable to suggest that the potential for conflict is higher, the greater the number of investors involved in any given deal.

Harvesting Investments

In general, private investors are patient investors expecting to liquidate their investment within five years. A majority (60%) of investors in the Postma and Sullivan study (1990) expected to hold on to their investment for at least six years. Riding (1993) concluded that Canadian private investors surveyed followed a "7/7 rule" seeking a seven-fold after-tax return on capital invested over a seven year holding period. A significant number of investors in a number of studies did not consider the timing of exit to be an important issue (Wetzel 1981; Mason, Harrison and Chaloner 1991; Landström 1993; van Osnabrugge 1998b). One study in the US (Freear, Sohl and Wetzel 1990) sought entrepreneur's views of private investors and venture capitalists and found that, on the whole, respondents considered private investors to be somewhat less patient investors (median = 4.75 years to exit) than venture capitalists (median = 5 years to exit) although the magnitude of the difference is rather small.

Investment Performance

The measurement of investment performance is a particularly difficult issue for a number of reasons, including:

- in the very early stages ventures typically operate at a loss and have a limited track record of performance;
- the difficulties associated with valuing highly illiquid equity stakes in privately-held companies generally; and
- the sensitivity of valuations, and hence investment returns, to the state of equity markets at the time of exit.

Many studies employ the use of subjective assessments of performance. While objective measures where available would be preferable, a strong argument has been made in support of reliance on subjective measures of performance (Brush and Vanderwerf 1992).

In general, a majority of the respondents in three surveys (Harrison and Mason 1992a; Gaston 1989a; Landström 1993, Riding and Short 1987b) reported that their portfolios were meeting or exceeding their expectations. Approximately 30% of the investors surveyed in the US and Sweden expressed dissatisfaction with the performance of their portfolio; in excess of 40% of UK investors expressed a similar sentiment. The relatively greater degree of dissatisfaction expressed in the UK may be a reflection of the fact that, on balance, UK investors require higher returns on their portfolios than do investors in the US or Sweden.

Lumme, Mason and Suomi (1996) analysed the actual returns achieved on forty investments made by Finnish private investors. One-third of the investments provided returns in excess of breakeven and one in five realised greater than 20% internal rate of return. Almost one in five investments resulted in a partial loss and more than one-third were total loss situations. Where an investor earned a positive return, it was equally likely that exit was made by either a trade sale or through the sale of shares to other shareholders or another third party.

2.7 Post Investment Involvement

The typical private investor assumes an active role in investee companies. Evidence from the US (Wetzel 1981; Tymes and Krasner 1983; Gaston 1989a; Freear Sohl and Wetzel 1990), Canada (Venture Economics 1990), the UK (Mason, Harrison and Chaloner 1991; Mason, Harrison and Allen 1995), and Sweden (Landström 1993) indicate that a vast majority, usually 75% or more, of investors can be considered "active" although a substantial minority prefer to manage their investments in a "passive" fashion, receiving only periodic financial and operating reports. Freear, Sohl and Wetzel (1990) raised the possibility that some passive investors may have invested as part of a syndicate with at least one other co-investor assuming an active role in the investee firm; in this respect, the proportion of truly "solo" passive investors may be quite small indeed.

A number of reasons can be advanced for private investors wanting to play an active, "hands on" role in the investee company. First, active involvement in a new venture and the entrepreneurial process has been identified as a primary non-financial motivation for investment, a "hot button" to borrow Wetzel's phrase (1981). Second, "hands on" involvement with ventures may serve to minimise potential agency risks between the investor and entrepreneur through the reduction of information asymmetries. Third, private investors have the opportunity to bring their particular skills, knowledge and experience to bear in the venture development process; contributions which hopefully positively affect venture performance, hence "adding value" to their investments. The notion of "added value" is alluded to in the 3i study which concluded: "Their (private investor) acumen is invaluable to even the most experienced of management teams and this can be the difference between success and failure" (3i 1994).

In what ways do private investors provide "hands on" assistance to investee firms? How much time does a "typical" investor spend in the venture? How effective are investors in performing these roles? It is to these questions that we now turn.

Forms of Post Investment Involvement

Generally speaking, active investors participate in investee businesses in a number of ways as summarised in Table 2.2. Board membership seems to be the most common form of participation, followed closely by the provision of consulting assistance to the venture. In a significant minority of cases, the private investor also works in the business on a part or full-time basis.

A number of studies have examined in greater detail the specific contributions made by private investors in investee businesses. Harrison and Mason (1992b) provided thirty-six entrepreneurs who had raised capital from a private investor with a checklist of some nineteen potential contributions, mirroring a study of the formal venture capital industry in the US (Rosenstein et al. 1989). The findings of their study are summarised in Table 2.3.

A number of observations of note can be made about the data presented in Table 2.3. First, the breadth of contributions made by private investors to investee businesses is quite wide; fully 40% of the entrepreneurs reported that the investor provided "contacts with suppliers", a contribution which occupied last place in the overall ranking. Second, the two key investor contributions, as perceived by entrepreneurs, were related to issues of strategic change and acting as a sounding board for management. In the opinion of entrepreneurs, almost half of the investors did not make a contribution with respect to product and market development; this finding is somewhat surprising in view of the extensive industry and functional experience investors often bring to investee businesses. Third, approximately one-third of the entrepreneurs did not cite monitoring of either financial or operating performance to be an investor contribution, an indication that a substantial minority of investors is passive in nature.[22]

The results of a US survey of 22 firms in San Diego which received an injection of equity capital from a private investor (Ehrlich, De Noble, Moore and Weaver 1994) indicate that the four most important areas of investor involvement were: i) interfacing with the investor group; ii) monitoring financial performance, iii) serving as a sounding board for management, and iv) formulating business strategy. In many respects, the results are similar to those reported in the UK study cited above. The relatively greater importance attached to interfacing with the investor group in the US vis-á-vis the UK may be a reflection of: i) the greater propensity of US private investors to participate in syndicated deals, and/or ii) the complementary roles of private investors and venture capitalists in which the investor invests a small amount of capital in an early stage venture with the eventual aim of calling upon venture capitalists known to them to provide follow-on financing at some later stage (Freear and Wetzel 1990). Like their UK colleagues, private investors in the US are least involved in the areas of market and product development.

[22]Another plausible explanation is that investors participate as part of a syndicate of investors with another individual assuming an active role in the investee business.

Time Commitment

The amount of time an investor spends with an investee firm can be influenced by a number of factors including:

- the stage of development of the venture - investee business which have overcome "liabilities of newness" tend to require less direct attention from investors generally;
- the time period that has elapsed since the time of investment - with time, the investor may become more comfortable with, and have a better understanding of, the venture and the entrepreneur. In other words, information asymmetries should decrease over time, hence the need to interact may also reduce over time;
- the fit between the skills and experience of an investor and the specific needs of the venture - it seems reasonable to suggest that an investor will spend more time with an investee firm in situations where he possesses expertise in an area(s) where gap(s) exist in the venture;
- the distance between investor and investee - the greater the distance, the more difficult it is for an investor to interact directly with the entrepreneur on a frequent and sustained basis;
- the performance of the venture - one could reasonably expect that investors would spend a great deal of time with investee businesses experiencing explosive growth or in situations where performance is falling significantly below investor expectations.

The few studies that have directly measured the time committed to investee firms have all concluded that private investors do spend a great deal of time "nurturing" their investments. In the US, Neiswander (1985) reported that private investors spend an average of five hours per week with each venture in the first six months, and three and half hours per week thereafter. A typical UK private investor surveyed by 3i (1994) worked, on average, a little over one day per week per company; a result supported by Mason, Harrison and Allen's study (1995) - almost 44% of the respondents in their survey reported spending one or two days a week or more assisting their investee businesses; over one-quarter reported spending less than one day a month directly assisting the venture. Swedish investors in Landström's study (1993) spent, on average, twelve hours per month with investee firms.

It seems clear that private investors do devote a great deal of time to the ventures in which they invest. The implication of this high level of active involvement, *ceteris paribus*, is that a theoretical upper limit is placed on the number of investments an investor can reasonably have in his portfolio at any given time (3i 1994). This condition applies, however, so long as an investor chooses to operate solo or as a "lone wolf" (Gaston 1989a); it becomes feasible to increase the number of investments in a portfolio if the private investor is prepared to participate as part of a syndicate of investors. Policy makers should bear in mind that in trying to stimulate the number of investments made by private investors, beyond a certain point, they may be well advised to concentrate their efforts on facilitating the flow of information between investors, as well as between investors and entrepreneurs, with the view of harnessing the leverage effects made possible by syndication. Moreover, syndication alongside experienced private investors may very well encourage virgin investors to make their first investment thereby increasing both the supply of informal venture capital available for investment and the number of active investors.

Private Investor - Entrepreneur Relations

In view of the active role most investors play in investee companies coupled with, in many instances, their prior industry and/or new venture experience, the temptation exists for private investors to cross the fine line between maintaining a productive relationship with the venture and meddling (Wetzel 1994). The potential for interpersonal conflict between investor and entrepreneur is ever present, particularly during the formative early stages of venture development. The goal of both investor and entrepreneur alike is to effectively manage business risk; potential problems arise in trying to distinguish the roles implied by "managing a venture" (the entrepreneur's perspective) and "managing an investment" (the investor's perspective). Throughout this process of role definition, the interpersonal chemistry between the parties is an essential ingredient for building a productive working relationship based on shared goals and a commitment to a shared vision (Wetzel 1994).

Having said this, the evidence available, albeit limited, suggests that a majority of both investors and entrepreneurs considered their relationship to be productive and consensual in nature. Three-quarters of the entrepreneurs in one US survey (Freear, Sohl and Wetzel 1990) reported that the relationship with their private investor was productive. Mason, Harrison and Allen (1995) sought the opinions of nineteen investor/entrepreneur dyads in the UK. The number of investors who indicated that the relationship with the entrepreneur was productive outnumbered those that did not by a factor of two; interestingly, entrepreneurs were more inclined to view the relationship in more favourable terms than were investors. Moreover, almost three times as many entrepreneurs and investors alike considered their relationship to be consensual as opposed to adversarial in nature.

Effectiveness of Private Investor Interaction

We have established that private investors perform a number of roles and spend a great deal of time assisting investee firms and that, for the most part, entrepreneurs are reasonably satisfied with the working relationship with the investor. How effective are private investors in performing these various roles?

In a comparative study of ventures which had raised funds from a venture capitalist or a private investor (Ehrlich, DeNoble, Moore & Weaver 1994), entrepreneurs perceived that they contributed relatively more to the venture than did investors, based on a checklist of twenty items developed by MacMillan, Kulow & Khoylian (1988). Venture capital backed entrepreneurs were, generally speaking, satisfied with the level of investor participation. In comparison, entrepreneurs whose ventures received funds from private investors wanted to see more investor involvement in a number of areas including: i) obtaining alternative equity financing; ii) obtaining alternative debt financing; iii) serving as a sounding board for management, iv) developing professional support groups, v) managing crises/problems, vi) soliciting customers/suppliers, and vii) monitoring financial performance. Both groups of entrepreneurs were particularly keen to receive help in the area of financial management. It would appear that entrepreneurs backed by private investors are, on the whole, less satisfied with the involvement of private as opposed to venture capital investors.

UK entrepreneurs were asked to assess the contributions made by private investors in nineteen areas (Harrison and Mason 1992b), a summary of their responses are presented in the last column in Table 2.3. While entrepreneurs rated "developing a strategy to meet changing circumstances" as a critical investor contribution, in excess of one third of respondents considered the investor's contribution in this respect to be unhelpful. In terms of "serving as a sounding board to management" and "monitoring financial performance", entrepreneurs generally considered the contribution provided in a much more positive light. Considering that in most cases less than 60% of investors made a specific contribution in a particular area *and* in instances where a contribution was made, 40% or more of the respondents described the involvement as unhelpful in nature, one might conclude that entrepreneurs are dissatisfied to some extent with the quality of contributions made by an investor.

Before accepting this explanation carte blanche, a number of caveats should be noted. First, there is an implicit assumption that the checklist of contributions is exhaustive. Mason and Lumme (1995) note that one of the chief limitations of the "checklist approach" is the relatively stronger emphasis on strategic and networking as opposed to social and supportive roles. The importance of the "coach" and/or "mentor" role was highlighted by Wetzel (1994) and Mason, Harrison and Allen (1995). Second, it is reasonable to expect that the degree of importance placed on certain roles is both context[23] and temporal[24] specific. In their study of investments made through LINC[25], the nature of investor contribution changed in one-third of the investments and in over half the cases there had

[23]Landström (1992) identified five groups of influences including: i) investee business characteristics (innovation level, stage of development); ii) environmental characteristics (variability in markets and technology, nature of competition); iii) entrepreneur/management team characteristics (industry, small business, management and financial experience); iv) dyadic characteristics (relative equity ownership shares, distance between investor and venture); and v) investor characteristics (transformation process knowledge).

[24]The importance of various roles changes over time.

[25]LINC (the Local Investment Networking Company) is a not-for-profit network of 12 agencies located throughout the UK. The purpose of LINC is to assist ventures seeking investment capital to identify suitable potential private sources of equity capital from their database of 300 registered business angels.

been a change in the time committed to the investee business (Mason, Harrison and Allen 1995). Third, some entrepreneurs may harbour unduly high expectations of an investor - the "saviour syndrome" - standards which the investor may find impossible to meet.

2.8 "Knowns and Unknowns": Identifying the Gaps

Of one thing we can be certain, the informal venture capital phenomenon is only partially "visible". As a result, we, as researchers, must be careful to avoid falling into the trap of advancing "truths" as opposed to offering "informed judgements". In the absence of a complete knowledge of the elements and characteristics of all members of the population under study, any conclusions must, therefore, be considered tentative. Bearing this caveat in mind, we have learned a great deal about the underlying market dynamics by taking different "cuts" at various "slices of reality" in a number of different countries.

"Informed judgement" would suggest the following:

- in terms of scale, the informal venture capital market is a major source of equity capital in all of the countries in which research studies have been undertaken;
- the "typical" profile of an individual investor is a well educated, financially secure male with previous new venture experience, although it should be noted that the overall population is quite heterogeneous in character;
- within this heterogeneous population, there is a large number of investors who have not, as yet, made their first investment ("virgin investors") or invest rather infrequently *and* a relatively smaller number of highly active, large scale investors;
- investors are motivated both by the prospect of financial gain and "psychic hot buttons", including *inter alia* the feeling of playing an important role in the creation of a new firm;
- informal venture capital appears to be a highly "localised" phenomenon - private investors rely on a close circle of friends and business associates to locate investment opportunities and they tend to be actively involved with investee companies; as a result, investors display a tendency to invest close to their home base;
- private investors typically invest in smaller amounts and at earlier stages than do venture capital firms, leading some authors to suggest that a complementary relationship may exist between the informal and formal venture capital markets;

- informal investors do seem to contribute more to the venture than purely capital particularly in a supportive capacity as the entrepreneur can benefit from the experience of an investor who, more than likely, has been involved with new ventures previously;
- there is a large untapped pool of additional capital available for investment, however, market inefficiencies persist namely: i) the difficulties encountered by entrepreneurs and investors alike in trying to locate each other in a timely and cost effective manner, and ii) the shortage of good quality investment opportunities, a reflection perhaps of the inherent information asymmetries which exist between investor and entrepreneur in situations where a venture has a limited, if any, track record of performance and key market, production and technological uncertainties remain largely unresolved.

While measurable progress has been made to better comprehend the informal venture capital phenomenon, much work remains to be done. In their review of the "state of the art in entrepreneurship", Freear, Sohl and Wetzel (1997) highlighted a number of areas where "...there are substantial contributions to be made to increase our knowledge of the early-stage equity financing market." (64) including:

- defining the characteristics of an effective market for early-stage finance;
- estimating the potential size of the virgin investor pool;
- identifying techniques for tapping the know-how and capital of virgin investors;
- examining the interface between the informal and formal venture capital markets;
- gaining a better understanding of the ABC's (attitudes, behaviours, and characteristics) of private investors;
- acquiring additional insights into the nature of the underlying relationship between investor and entrepreneur;
- evaluating the performance of investment portfolios;
- uncovering information on the terms and conditions upon which informal venture capital can be obtained; and
- understanding the role of the public sector in the development of a vibrant informal venture capital market.

2.8 An Assessment of Research Undertaken to Date

In providing a critical assessment of the research that has been undertaken to date, one must be mindful that as a field of study, informal venture capital is a very young one. The mutually reinforcing needs for data and for access to build a base of knowledge upon which to explore an entirely new field of study necessitated that researchers devote time to locating potential respondents *and* once discovered, to gather what can broadly described "demographic" information from them. At first glance, one might reasonably draw the conclusion that the research undertaken to date is relatively simplistic and unsophisticated in nature. However in my opinion, the work that has been done to date provides an invaluable base from which to embark upon the task of developing our knowledge base in the field in a manner more "acceptable" to our colleagues in more established fields of study.

Having said this, a number of noteworthy observations concerning the state of research need to be made. First, for the most part the unit of analysis for most of the research to date has been the "investor" as opposed to the "deal". A thorough understanding of market behaviour and dynamics implies knowledge of both "transactors" and "transactions" in addition to the broader environment in which a market operates. Second, the vast majority of studies have relied on the views of investors alone and largely ignored those of entrepreneurs. There is a need to balance the "supply-side" (investors) view of the world with that of the "demand-side" (entrepreneurs). Third, in an effort to build a broadly comparable base of knowledge, many research studies, particularly those related to defining demographics, rely on replication of earlier work; for example the pioneering work of Wetzel in the US. While achieving some measure of consistency upon which to draw comparisons, the benefits of relying on a more eclectic approach might be foregone. Fourth, in large measure, the samples upon which researchers have drawn are databases maintained by market intermediaries of one form or another. While obviously appealing in terms of convenience, such a strategy introduces potential biases insofar as the experience of a significant element of the population may elude capture (those investors who do not rely on market intermediaries to find deal flow). Fifth, with few notable exceptions, the research design employed is neither theoretically based or relies on methods other than descriptive statistics as a basis for subsequent analysis. Finally, virtually all of the received research undertaken to date has been cross-sectional and not longitudinal in nature (Sohl 1999).

With the aim of making a meaningful contribution to our existing state of knowledge in the informal venture capital field, the design of this study addresses many of the issues raised above. The model we will develop for empirical testing draws on two complementary theoretical perspectives "borrowed" from the field of industrial economics, transaction cost economics and agency theory, as a basis for hypothesis development. As described in more detail in Chapter 5, the survey instrument developed captures data on actual completed deals. Moreover, by design we have tried to tap into a sample of potential respondents from a variety of different sources. Having said this, in view of the resource constraints and in an effort to minimise the time commitment required of participants, we obtained data from investors only, relied on business introduction services in part to reach target respondents and employed a cross-sectional research design.

2.9 Concluding Remarks

In this chapter, we have provided a summary of the findings of a substantial and growing body of research in what can still be considered an emerging field of study, informal venture capital. In addition to providing a contextual backdrop for our study, a review of the received literature in this field was necessary to lay the groundwork at a later stage for assessing the contribution of this study within a broader field of enquiry.

In exploring the linkage between contextual factors and the decisions investors make with respect to how to structure their economic relationship with the entrepreneur, this study addresses a significant knowledge gap in the field. As with any emerging field of study, the theoretical foundations of the informal venture capital area are largely undeveloped (Freear, Sohl and Wetzel 1997). Relatively few studies have used theoretical perspectives developed in related fields of enquiry as a basis for developing models and hypotheses for empirical testing. Two potentially useful theoretical perspectives, transaction cost economics and agency theory, have begun to be used as a basis for developing testable hypotheses (Fiet 1991; 1995a, 1995b; Landström 1992; van Osnabrugge 1999). While exploratory in nature, this study aims to build upon this base of earlier work and contribute in some small way to the ongoing and never ending process of theory development to explain the underlying dynamics of the informal venture capital market. To this end, in the chapter that follows, we will: i) review the relevant literature pertaining to both transaction cost economics and agency theory perspectives; ii) assess the potential usefulness of extending these theoretical lenses into the domain of informal venture capital; and iii) summarise the research which has been undertaken in the field of entrepreneurial finance that has relied on one or both of these perspectives for guidance.

Table 2.1: Comparative Analysis of "Typical" Investor Profiles

Characteristic	Sunbelt Region USA[1]	New England States[2]	Ottawa-Carleton[3]	United Kingdom[4]	Sweden[5]	Finland[6]
Age	49 years	47 years	50 years	53 years	73% (45-64 years)	67% (40-60 years)
Sex	Male	n/a	Male	Male	Male	Male
Family Income	$ 70,000US	n/a	>$150,000Cdn	£ 46,000	60% (>$ 91,000US)	n/a
Net Worth	$750,000US	n/a	>$1 million Cdn	£312,000	57% (>$909,000US)	n/a
Number of Past Investments	2 every 3 years	1 every 2 years	1 every year	2 every 3 years	3 every 3 years	1 every 3 years
Average Value of Investments	$37,500US	$50,000US	$109,000Cdn	£10,000	$73,000US	75% (<$175,000)
Involvement With Firm	Consulting help	Board of Directors or Consulting	Board of Directors	Board of Directors, Informal Consulting Help	Board of Directors, Consulting Help	n/a
Voting Control	50%	n/a	<10%	10%-24%	65% (<50% equity)	n/a
Geographic Preferences	within 50 miles	within 50 miles	within 300 miles	within 50 miles	n/a	within 50 miles
Business/Industry	Manufacturing, Finance, Real Estate	High Technology, Manufacturing	High Technology, Manufacturing	Consumer Services, Distribution, High Technology, Finance, Manufacturing	Finance, Real Estate, Manufacturing, Industrial Products	Manufacturing, Services, High Technology
Rejected Opportunities	2 per year	2 - 3 per year	6 per year	4 per year	2 per year	5-6 per year
Minimum Required Rate of Return	20%	20%	32%	31%	15%	n/a
Liquidation Expectations	3 - 4 years	5 - 7 years	5 years	3 - 5 years	41% (3 - 5 years)	3-5 years
Future Investments	1 in next year	1 per year	1 in next year	n/a	n/a	n/a
Primary Source of Opportunities	Friends, Business Associates	Friends, Business Associates	Friends, Business Associates	Friends, Business Associates	Friends, Business Associates, Active Search	Business Associates Friends
Previous Start-up Experience	<50%	78%	84%	67%	96%	95%
Dissatisfication With Existing Communication Channels	33% dissatisfaction	65% dissatisfaction	33% dissatisfaction	47% dissatified/very dissatisfied	n/a	n/a
	N = 158	N = 133	N = 25	N = 86	N= 52	N = 38

Table Adapted From: Harrison and Mason (1992)
Sources: [1]Gaston and Bell (1988); [2]Wetzel (1981b); [3]Short and Riding (1989); [4]Mason, Harrison, and Chaloner (1991); [5]Landström (1993); [6]Suomi and Lumme (1994)

TABLE 2.2: The Nature of Participation By Private Investors in their Investee Businesses[1]

		No Role (Passive)	Board Membership	Consulting Assistance	Working in Venture	Other / Unknown
USA:	(a)	17%	15%	29%	39%	-
	(b)	20%	----------- 58%	--------------	18%	4%
	(c)	20%	51%	56%	20%	-
Canada		15%	31%	28%	25%	1%
UK:	(a)	31%	27%	21%	16%	5%
	(b)	10%	41%	30%	19%	-
Sweden		7%	56%	28%	7%	1%

Sources: USA (a): Gaston (1989a); (b) Freear, Sohl and Wetzel (1990); (c) Tymes and Krasner (1983); Canada: Venture Economics (1990); UK: (a) Mason and Harrison (1994c); (b) Mason, Harrison and Chaloner (1991); Sweden: Landström (1993).

[1]Adapted from Mason and Lumme (1995).

TABLE 2.3:

Contributions of Private Investors to Their Investee Businesses: The Entrepreneur's Perspective

Rank	Contribution	% of Investors Making This Contribution
1	Development of new business strategy to meet changing circumstances (strategic change)	75.0
2	Serving as a sounding board to the management team	72.2
3	Monitoring financial performance	66.6
4=	Monitoring operating performance	63.9
4=	Development of a marketing plan	63.9
6=	Interface with other members of the investor group	61.1
6=	Evaluation of marketing plan	61.1
6=	Evaluation of product/market opportunities	61.1
9=	Assistance in short-term crises/problems	58.3
9=	Development of actual products/services	58.3
11=	Help in obtaining other sources of equity finance	55.6
11=	Motivating personnel	55.6
11=	Providing contacts with customers	55.6
14=	Development of original business strategy	52.8
14=	Replacement of members of the management team	52.8
14=	Development of product/service techniques	52.8
17	Recruitment of members of the management team	47.3
18	Help in obtaining sources of debt finance	41.7
19	Providing contacts with suppliers	38.9

Source: Harrison and Mason (1992b)

CHAPTER 3: THEORETICAL FRAMEWORK

3.0 Introduction

In many respects, the issue of how to structure the economic relationship between any two parties is a central concern in the fields of industrial economics and strategic management alike. It is a basic premise of this study that the means by which investors choose to structure their relationship with the entrepreneur is shaped by the context within which these decisions are embedded (Barney & Ouchi 1986). In this chapter, two complementary perspectives are discussed which will form the theoretical underpinning for the development of testable hypotheses to be discussed in the chapter to follow.

The transaction cost economics perspective focuses on the structure that evolves to co-ordinate the exchange between investor and entrepreneur. These governance choices are shaped both by the underlying nature of the economic transaction and the parties to the exchange. Contextual factors are also the central focus of the agency theory perspective that examines the impact that information asymmetries between the parties to an exchange can have on ultimate outcomes. Opportunism is a common link between the transaction cost economics and agency theory perspectives, although the former is far more general in scope encompassing not only the propensity of parties to an exchange to behave in a manner detrimental to the welfare of the counterparty ("agency risk") but on the characteristics of the transaction itself ("business risk").

The aim of this chapter is to: i) define the underlying structure of markets implied by both transaction cost economics and agency theory and assess the degree of fit with the perceived structure of the informal venture capital market; ii) provide an overview of both theoretical perspectives; iii) discuss the merits and limitations of extending these theoretical lenses into the domain of informal venture capital; and iv) summarise the empirical work in the entrepreneurial finance literature which has relied on either or both of these theoretical lenses and in so doing, place the contribution of this research into context.

3.1 How Markets Are Structured

In a general sense, both the transaction cost economics and agency theory perspectives share a similar view of market structure. It is important at the outset to highlight in what respects the informal venture capital market is similar in structure to, or differs in character from, the term "market" as espoused by both transaction cost economics scholars and agency theorists alike. In so doing, we shall be able to highlight potential bases for extending the use of these perspectives into the domain of informal venture capital as well as the potential limitations that may call such efforts into question.

To both transaction cost economists and agency theorists, markets involve exchanges between self-interest seeking individuals who must choose how to structure their relationship on the basis of incomplete information, particularly concerning the intentions and capabilities of their prospective exchange partner. The identification of options and the acquisition of information about specific agents imply costly search activities. The detrimental effects of self-interesting seeking behaviour on the part of the counterparty is mitigated by: i) the manner in which the transactor chooses to effect the exchange (in-house, spot-market or some intermediate form), ii) monitoring activities of the principal, and/or iii) the structure of the incentive system established with the agent ex ante. The objective function is to ensure that individual exchanges are structured efficiently, that is to say in a manner that curbs undesirable self-interest seeking behaviour at least cost to the transactors.

In some notable respects the informal venture capital "market" does bear some resemblance to the structure portrayed above. First, investors do find it difficult to uncover promising investment opportunities or identify options (Harrison and Mason 1996b). Second, once identified, private investors do incur costs both in terms of time and money to gather information to fully assess the risks associated with a given opportunity (van Osnabrugge 1999). Third, as the previous chapter highlighted, private investors are typically active participants in the venture development process, a means by which activities of the entrepreneur can be monitored. Fourth, received research also supports the view that one of the most significant negotiating points between the two parties is in determining relative equity stakes in the venture, or in other words, the incentive structure (Benjamin and Margulis 1996). Fifth, there is an implied power structure favouring the transactor (the buyer does not have to buy) that is conceptually appealing to the informal venture capital market (the investor does not have to invest) (Benjamin and Margulis 1996).

In other respects, however, the structure of the informal venture capital market differs from that portrayed by transaction cost economics and agency theory. First, investment opportunities are highly specific to particular individual(s); the business is so intimately tied to the people pursuing it and vice versa that no effective "replacement market" exists for the entrepreneur in many instances (Cable and Shane 1997). Second, and this argument mirrors the first, the experience of the private investor(s) is also unique and thus no true replacement market exists for them either (Benjamin and Margulis 1996). Third, received research has also demonstrated that both entrepreneurs and investors are not motivated *solely* by the pursuit of their own economic self-interest (Wetzel 1981). Aside from creating wealth for themselves, entrepreneurs seek a measure of control over their lives, they like to build things, they thrive on challenge and want to make a positive societal contribution. For their part, private investors are also motivated by a number of non-financial psychic hot buttons as described in the previous chapter. In short, it appears that the transaction between private investor and entrepreneur is infused with relational as well as discrete contractual elements (Macneil 1980). Fourth, there is also reason to believe that the implied hierarchical relationship that exists between buyer and seller does not strictly hold between private investor and entrepreneur and that opportunism can be equally problematic for entrepreneurs (agents) as well as investors (principals) (Sapienza and Gupta 1994).

In many respects, one of the underlying fundamental questions of this study is to begin to address the question as to whether the informal venture capital market strictly behaves as a market in the sense implied by transaction cost economists and agency theorists. To the extent that it does, we can begin to build the theoretical foundations, with transaction cost economics and agency theory as an important base, to enhance our understanding of not only the structure but of the underlying market dynamics as well. If however, we find that the underlying structure of exchanges is more relational in character and differs in some fundamental ways from that espoused by transaction cost economics and agency theory, we have begun to establish their boundaries of extendibility.

In the remainder of this chapter, we will discuss each of the theoretical perspectives in turn and provide a critical assessment of the benefits and drawbacks of extending each into the domain of informal venture capital. We shall also round out the discussion by briefly summarising the received research in entrepreneurial finance that has relied on either or both theoretical perspectives as a basis for study. It is to the discussion of the transaction cost economics perspective that we now turn.

3.2 The Transaction Cost Economics Perspective

Focusing on the economic exchange between parties (the "transaction"), this perspective examines how contextual factors, both environmental and human in nature, shape the choices that are made as to how these transactions are structured. Within this perspective, "markets" and "hierarchies" (read firms) are viewed as alternative governance structures[1] (Williamson 1975). The transaction cost perspective seeks to address the issue of how to: "...assign transactions (which differ in their attributes) to governance structures (the adaptive capacities and associated costs of which differ) in a discriminating way" (Williamson 1985: 18). The existence of "hybrids" - transactions which are effected through the use of mechanisms such as licensing agreements or subcontract arrangements - was acknowledged as an intermediate governance structure that lies between hierarchies on the one hand and markets on the other (Williamson 1985). The selection of one governance structure over another is, in large measure, guided by the strict efficiency criterion of transaction cost minimisation. While the level of analysis for much of the received research is the "firm", economic transactions are consummated by individuals. As a result, one can argue that the underlying logic of the transaction cost perspective may also be usefully extended to exchanges involving individuals.

3.3 The Transaction Cost Perspective: An Overview

Two fundamental assumptions about people underpin the transaction cost perspective: i) human beings, in general, are "boundedly rational" (Simon 1961); and ii) that some people are prone to behave opportunistically. The assumption of bounded rationality implies that while human beings strive to be rational in their decision-making they can only be partially successful in achieving this objective because of information processing limitations. The assumption of opportunism[2] implies that *some* individuals party to an exchange will pursue their self-interest to an extreme, to the point of strategically misrepresenting their situation to

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[1]Hudson & McArthur define a contractual governance structure as: "...(the) basic terms specifying who are the contracting parties, what property rights are being exchanged, when and where the exchange will take place, and how the exchange will occur. These terms allocate risk and responsibilities among the contracting partners." (1994:47)

[2]Williamson defines opportunism as "...lack of candour or honesty in transactions, to include self-interest seeking with guile."(1975: 9)

their exchange partner.[3]

According to Williamson (1975; 1979; 1985), governance structures are devised by parties to an economic exchange as a means of: i) dealing with unanticipated future events both as a result of unforeseen environmental disturbances and the inability of parties to a contract to stipulate all possible future contingencies within the contract ex ante (MacNeil 1978); and ii) protecting themselves from counter-party opportunistic behaviour, actions which may adversely impact their own welfare. At the firm level of analysis, Williamson developed the transaction cost framework to understand the choices firms face with respect to relying on outside parties totally by engaging in spot exchanges ("market") versus incorporating activities within ("hierarchy"). Initially he ignored the possibility of other forms of exchange which lie between "markets" and "hierarchies", but later acknowledged the existence of "hybrid" governance structures such as joint ventures, licensing agreements and the like. The choice of one form of governance structure over another is based on the strict criterion of economic efficiency, choose the structure which minimises transactions costs (Williamson 1975; 1979; 1985; Oviatt 1988), including the ex ante costs of negotiating and writing the contract and the ex post costs associated with monitoring compliance with, and enforcing terms of, the contract[4].

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[3]It is important to note that Williamson does not assume that *all human beings* behave opportunistically *all of the time*, rather that *some of them* behave opportunistically *some of the time.* Moreover, it is difficult to discern which individuals belong to which group either ex ante (adverse selection problem) or ex post (moral hazard problem).

[4]Various safeguards can be included as part of the contract to protect the parties to the agreement from the effects of either unintended events or undesirable behaviours. Ring & Van de Ven (1992) distinguish between two types of endogenous safeguards: i) *structural* safeguards which include the provision of collateral, board membership, contingent claims and/or explicit performance specifications which are written into the agreement; and ii) *procedural* safeguards which can include auditing and/or monitoring rights and the inclusion of a specific dispute resolution mechanism within the contract itself. It is also important to note that governance mechanisms are "embedded" within a legal system which provides parties with varying forms of legal safeguards in addition to the structural and procedural ones which are explicitly provided for in a contractual relationship between two or more parties.

Central to Williamson's argument is that the choice of governance structure is also influenced by the nature of the underlying economic transaction; in other words, context matters. He argued that economic transactions differ with respect to: i) the extent to which they are supported by transaction specific investments[5] (Teece 1985; Klein, Crawford & Alchian 1978); ii) the degree of uncertainty present; and iii) the frequency with which the transaction recurs. Firms should favour incorporating activities "in house" when transactions are: i) supported by transaction specific investments; ii) highly uncertain; and iii) recurrent in nature.

To deal with the inherent governance challenges associated with: i) incomplete contracts; and ii) potential opportunistic behaviour on the part of one or both of the contracting parties, advocates of the transaction cost perspective should structure their relationship in manner that is both highly specific and flexible. While it is highly desirable for parties to stipulate their respective rights and obligations in detail, it is simply not possible to foresee all of the potential areas of dispute that may arise in the future. Hence, a degree of flexibility needs to be built into contracts ex ante to adapt to changed circumstances ex post, for example by agreeing on the manner in which disputes arising from future unforeseen circumstances is handled ex ante.

In summary, the transaction cost perspective maintains that it should be possible for parties to structure their economic relationship in a manner that promotes and protects the interests of each with a high degree of precision while incorporating a measure of flexibility to adapt to change over time. The degree of precision and care required in crafting this governance structure is a function of: i) characteristics of the parties to the exchange; and ii) transactional attributes. Comprehensive (and costly) governance structures should be prevalent in economic relationships characterised by high levels of uncertainty and where

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[5]Transaction specific investments can be in physical assets and/or people. Asset specificity refers to the difficulty of redeploying physical or human capital to another use. To the extent that physical assets are immovable, location can also create a "lock in" effect, or what is commonly referred to in the strategic management literature as switching costs.

opportunism may be problematic.

3.4 Merits of the Transaction Cost Perspective in the Informal Venture Capital Arena

While much of the received research has been concerned with the choices faced by firms as to whether to effect a given economic transaction in the spot market, in-house or through some form of collaborative relationship with an outside party, the underlying logic of the transaction cost perspective may be usefully applied to exchanges between individuals, in this case investors and entrepreneurs. In the informal venture capital market, investors face the choice of whether to invest at all, and if so, on what terms and conditions. The transacting parties face difficulties in predicting future outcomes with accuracy and fully understanding the linkages between individual effort and outcomes. Moreover, investors also face the inherent challenge of assessing the competence and integrity of the entrepreneur in whose efforts they place capital at risk.

As Benjamin and Margulis (1996) alluded throughout their book, investors derive some measure of power from the fact that they alone decide to provide or withhold finance from a particular entrepreneur as unlike venture capital fund managers, "they do not have to invest". When they place their own capital at risk, it is reasonable to suggest that most private investors establish some form of governance structure to protect and promote their interests at the time the investment is made. The contractual agreements that are struck between private investor and entrepreneur would appear to be a particularly fertile area to empirically test Williamson's notions about the linkage between governance choices and the context in which these choices are made. Backing an entrepreneur is, in many cases, a highly asset specific investment - the entrepreneur may prove to be "virtually irreplaceable". Moreover, private investors often place capital at risk in ventures: i) where market and technological uncertainties are largely unresolved at the time of investment; ii) which are often lead by individual(s) with limited experience in building new ventures; and iii) competing in an industry setting where the investor may have little or no previous relevant experience. Under such conditions of uncertainty, the threat of opportunistic behaviour by the entrepreneur may be problematic as the distribution of knowledge across the investor-entrepreneur interface may, at times, be heavily skewed in favour of the entrepreneur.[6]

Faced with the threat of opportunism under conditions of high asset specificity and uncertainty, Williamson's logic would call for the establishment of a comprehensive governance structure. Operating in this context, one would expect investors to: i) spell out in explicit detail what behaviour is expected from the entrepreneur within the shareholder's agreement; ii) require the entrepreneur to post bonds or increase the perceived cost of defection to them; iii) take steps to actively monitor the development of the venture on a formal (employment, board representation) and/or informal (ad hoc consulting advice) basis, and iv) to agree upon some manner upon which to resolve future disputes between the parties. Ideally, the structure developed would serve to curb opportunism while at the same time afford the flexibility for the parties to respond effectively to changed circumstances.

3.5 Limitations of the Transaction Cost Perspective in the Informal Venture Capital Arena

However, there are reasons to believe that relying on the transaction cost perspective as a theoretical lens does have limitations, particularly when extended to the field of informal venture capital. First, the nature of the decisions which the transaction cost perspective sought to explain, namely when does it make sense to buy in markets, produce in-house, or arrange transactions in some other manner such as joint ventures, implies a focus on issues

[6]Although it should be noted that research has consistently demonstrated that a large majority of private investors, usually 75% or more, have prior direct experience in the new venture setting. If "venture building skills" are indeed generalisable to a number of industry settings, the degree of information asymmetry that exists between investor and entrepreneur may not be as skewed in favour of the entrepreneur as first thought.

faced by larger, established businesses. To the extent that larger and established businesses are often publicly-traded, there potentially exists significant differences with respect to the type of firm towards which the transaction cost perspective is orientated as compared to the small, newly-established unquoted firms most private investors transact with.

Of particular concern are the distinctions to be drawn between public and private ownership structure. Shareholders in large, publicly-traded firms can signal their displeasure with management by selling their equity stakes expediently and at fair market value (Walsh & Seward 1990). Moreover, large institutional shareholders can seek representation on the board of directors that, in theory, maintains the final say over all corporate decisions and has the power to decide who holds senior management positions in the company. To the extent that numerous suitably qualified replacements can be found, this external mechanism of control is quite credible (Walsh & Seward 1990). On the other hand, private investors face both real liquidity constraints *and* demonstrably inefficient external markets for management talent (Cable & Shane 1997). In short, there is reason to believe that two key external mechanisms by which an investor can signal their displeasure concerning the management of the company are absent and thus that the nature of the "firm" is quite different.

Second, the transaction cost perspective leaves little room for trust to develop or prevail between the parties. The inherent tone of the perspective is defensive and protective in nature. While contract specificity and attention to contractual detail do help to clarify and make transparent the respective rights and responsibilities of the transacting parties, there appears to be little attention paid to the impact such an approach has with respect to the attitudes of the individual parties concerned.[7] Transacting on the basis of trust would appear to be especially important for entrepreneurs, an individual which received research would

[7] A number of authors have noted that economic exchanges take on a much more positive character being infused with trust as opposed to opportunism with the result that fewer safeguards need to be included which, in turn, reduces overall transaction costs. See for example Granovetter (1985), Larson (1992), and Ring & Van de Ven (1992).

characterise as having a high locus of internal control. To entrepreneurs, the presence of numerous perceived, if not real, constraints on their behaviour may be a powerful disincentive, a point reiterated by Ghoshal & Moran (1996) in their critique of the transaction cost perspective. They concluded that: "...even though sanctions can undoubtedly promote certain specific behaviours and deter others, elements of governance mechanisms such as surveillance and fiat have consistently been shown to have negative effects on individual attitudes toward the specific behaviour that is targeted."(1996: 20). Beyond a certain point, the authors imply that trying to identify and control all potential sources of governance challenge can do more harm than good. The relationship that develops between the parties appears to be an important lubricant for the inherently incomplete contracts that are struck between investors and entrepreneurs to be implemented in practice (Cable and Shane 1997).

Third, received research would support the view that private investors, or for that matter entrepreneurs, are driven solely by economic self-interest as transaction cost economics implies (see Sullivan 1994 for example). Private investors are prepared to trade-off financial returns for the opportunity to build something new, for the challenge of mastering new technology and for the fun of being involved in an entrepreneurial firm, among other reasons. For their part, entrepreneurs have diverse reasons other than accumulating wealth to start a business including a strongly perceived need for achievement and control over their own destiny, among others. Private investors appear to be attracted to situations where they can make a value added contribution to the venture's development beyond the mere provision of their capital and that they go to great lengths during the due diligence phase to assess the personal chemistry between themselves and the management team. In this respect, as Williamson conceded (1975), the atmosphere of the relationship between the parties is an important ingredient as is the contractual arrangement itself.

Finally, asset specificity is a problem that is faced by both investor and entrepreneur alike. Unlike most venture capitalists, private investors do bring a wealth of practical hands on experience building and running entrepreneurial businesses themselves. While this experience should prove useful in helping them form an opinion as to the attractiveness of a given opportunity and the quality and integrity of the people pursuing it, the potential for better informed and more experienced investors to behave in an opportunistic manner vis-à-vis the entrepreneur is a potential concern (Sapienza and Gupta 1994).

On balance, while there exists serious reasons to believe that the transaction cost perspective may not be strictly applied to the informal venture capital field, it nonetheless appears to offer useful insights to guide the development of theory in a largely unexplored field of enquiry. By their very nature, private equity transactions bring together individuals with virtually irreplaceable skills and experience (Cable and Shane 1997) often under conditions of great task uncertainty. Private investors are also effectively deprived the use of an important market discipline mechanism enjoyed by shareholders in publicly-companies, namely the ability to signal their displeasure with the actions of management by selling shares at fair market value in an expedient manner. While we believe that the informal venture capital market behaves in some fundamentally different ways than perhaps envisioned by transaction cost economists, the theoretical underpinnings of our field are at such an early stage of development that we should not dismiss the potential utility of the perspective on the basis of perceived inapplicability. Putting transaction cost economics to the test in the very unique environment of private equity transactions may help to establish the "limits of extendibility" of this theoretical perspective.

3.6 The Agency Theory Perspective

Where the transaction cost perspective views the firm as a governance structure, the agency theory perspective views the firm as a nexus of contractual relationships[8] (Alchian & Demsetz 1972; Jensen & Meckling 1976). An agency relationship is said to exist when one individual (the principal) engages the services of another individual (the agent) to perform a service on their behalf. In so doing, a measure of decision-making authority is delegated from principal to agent. The central concern of the agency theory perspective is opportunism; the risk that the agent will take decisions that are not always in the best interests of the principal. Goal divergence between principal and agent is a potential problem in any situation characterised by both high levels of uncertainty and asymmetric distribution of information[9] in favour of the agent (Levinthal 1988).

For their part, principals are aware of the potential for agents to act opportunistically and can respond to this agency risk by building in contractual safeguards ex ante, which includes the establishment of monitoring systems, and implementing incentive schemes to influence agent behaviour in a manner consistent with the goals of the principal[10]. The effectiveness of such measures will be dependent on the principal's ability to not only observe agent behaviour but to accurately discern the underlying cause-effect relationship at work between agent effort and outcomes. The emphasis on monitoring systems and safeguards is consistent with the transaction cost perspective and both perspectives view the board of directors as a key mechanism for directing management (agent) behaviour in particular ways. Unlike the transaction cost perspective, which relies on contractual provisions and dispute resolution

[8]Which includes not only written contracts but any implicit bargaining processes between parties over outcomes.

[9]Ackerlof (1970) was one of the first scholars to highlight this problem in examining the market for information on used automobiles.

[10]Most work in the field adopts the neoclassical approach of defining principal goals strictly in wealth maximisation terms.

mechanisms to handle the adaptation problem, the hallmark of the agency theory perspective is the reliance on the incentive system to instil the necessary degree of flexibility into the economic relationship to solve the adaptation problem of responding to unanticipated changes ex post.

In a world of costless and perfect information, principals are able to continually observe agent effort and accurately attribute their actions to outcomes with the objective of ensuring that the agent acts at all times in the best interest of the principal. Agents would be technically indifferent to being compensated on the basis of behaviour and/or outcomes as the means of transformation and outcomes are known with certainty ex ante. Where information is imperfect and/or costly to obtain, the use of monitoring and/or incentive schemes becomes problematic. It is simply not possible to: i) continually observe agent behaviour save for the incurrance of large monitoring costs by the principal; and ii) establish the linkage between behaviour and outcome with certainty. Cognisant of these inherent real world obstacles to monitoring, principals sometimes will impose risk on, what are often assumed to be, risk averse agents by contracting, in whole or in part, on the basis of outcomes. Risk is imposed on the agent insofar as outcomes are in part attributable to their own effort and in part to environmental influences over which they may exercise little direct control (Levinthal 1988)[11].

It is strongly implied in the literature that agency risk can be reduced but, in a world of incomplete and costly information, can never be eliminated[12]. As a result, principals compensate for this inherent agency risk by reducing the price they are prepared to pay for a given equity stake in the firm to reflect the "costs" associated with "inevitable" sub-optimal

[11]For an excellent discussion of the impact of strategic choice versus environmental determinism on organisational performance see Walsh & Seward (1990).

[12]As Levinthal (1988) so aptly stated: "Agency models of organizations are developed in a setting in which standards of desirability are precise and there is incomplete knowledge of cause/effect relationships." (154)

agent behaviour. In this respect, agency risk is, and should be, a central concern of the entrepreneurship field.

Far from being a relatively "new" phenomenon, agency risk was recognised as a problem in 1776 by Adam Smith who noted: "The directors of such (joint-stock) companies, however, being the managers rather of other people's money than of their own, it cannot be well expected, that they should watch over it with the same anxious vigilance with which the partners in a private copartnery frequently watch over their own ... Negligence and profusion, therefore, must always prevail, more or less, in the management of the affairs of such a company." (1937:700)

3.7 The Agency Theory Perspective: An Overview

Both the agency and transaction cost perspectives focus on the terms of the agreement between the principal (the "investor") and the agent (the "entrepreneur"). Consistent with the transaction cost perspective, the agency theory perspective assumes that human beings are boundedly rational. Both principals and agents are assumed to be rational economic maximising individuals that act in accordance with their self-interest. Opportunism is a primary concern for agency theorists who work from the assumption that agents, in general, are better informed than principals concerning: i) their true level of skills and abilities (the "adverse selection" problem); and ii) the level of effort that is expended on a given task on behalf of, and for the ultimate benefit of, the principal (the "moral hazard" problem)[13].

In general, the agency theory perspective attempts to resolve problems which can occur when parties to a contract have divergent goals, particularly in situations where the

[13]Lambert (1983) and Holmstrom (1979) noted that the moral hazard problem can be alleviated as a result of repeated interactions between principal and agent. With the passage of time, principals obtain additional information and insights on both the "true" level of agent skill and effort. In effect, agents take steps to develop a reputation for behaving in a manner consistent with the principal's interests (Levinthal 1988).

knowledge of the agent is highly specialised and it is difficult to locate a comparable replacement for him (Jensen & Meckling 1976). The agency theory perspective is also concerned about the impact that differing risk preferences of the parties can have on the decisions that are taken[14]. "The major problems highlighted by the agency theory perspective are those of establishing and maintaining mutually satisfactory behaviour on the part of potentially conflicting and self-interested stakeholders when information about the contractors, particularly the agents, and the tasks is costly, uncertain, incomplete, and asymmetrically distributed among the parties." (Oviatt 1988: 215)

Berle & Means (1932) were among the first scholars to note that the separation of ownership from control, particularly in large, publicly traded companies, where management typically hold negligible equity stakes, can lead to a situation where agents (management) are taking decisions which are not strictly in the long term best interest of the principal (shareholders). With the aim of bringing the interests of principal and agent into closer alignment, agency theorists argue that costs are incurred by the parties to the contract including: i) those associated with the negotiation and drafting of contractual agreements which specify the rights and obligations of parties to the agreement; ii) monitoring costs incurred by the principal in trying to influence and/or control the behaviour of the agent; iii) bonding costs which arise from efforts of the agent to demonstrate compliance with the wishes of the principal; and iv) the residual loss which occurs as a result of inevitable sub-optimal decision making by the agent (Jensen & Meckling 1976). There is a strong incentive for agents to minimise these agency costs as principals will factor them into the price they are prepared to pay for a given equity stake in the firm (Jensen & Meckling 1976). It is important to note,

[14]Much of the received research to date assumes that agents are risk averse - agents will always prefer to receive a fixed certain sum today as opposed to an equivalent, but uncertain sum at some point in the future (Lambert 1983). Fama & Jensen (1983a) argue that when risk is shared equally between principal and agent, it follows that it is in the best interest of the agent to work in the principal's best interest. In effect, the contract becomes self-enforcing with self-interest being contained through shared decision making between the parties. It should be noted, however, that "risk" is a difficult construct to measure as it involves an element of perception and is dynamic in nature.

however, that agency costs can never be zero if the assumptions of bounded rationality and information asymmetry hold[15].

The development of agency theory has followed two distinct routes (Eisenhardt 1989). Both approaches rely on the contract as the unit of analysis and the objective function of each is to economise on agency costs. The *positivist stream* seeks to identify situations where goal conflict between principal and agent may become problematic and describes the governance mechanism that curbs self-interested behaviour by the agent. Empirical work in this stream of research has focused mainly on the separation of ownership and control in large, publicly traded firms (Jensen & Meckling 1976; Fama 1980; Fama & Jensen 1983b). Where the interests of principal and agent diverge, the aim of positive agency theory is to demonstrate that monitoring and/or incentive systems "solve" the agency problem. In contrast, the *principal-agent research stream* tends to be much more stylised and abstract in approach seeking to develop a refined mathematical model of the principal-agent relationship that efficiently allocates risk among the parties (see for example Shavell 1979).

3.8 Merits of the Agency Theory Perspective in the Informal Venture Capital Arena

The problems associated with inducing desired behaviour from individuals has long been recognised as an important managerial imperative (Berle & Means 1932; Barnard 1936). In a sense, the intuitive appeal of the agency theory perspective is rooted not only in the recognition that the "agency problem" has been around for a long time but that the perspective itself is widely generalisable. Jensen & Meckling (1976) stated: "The problem of inducing an "agent" to behave as if he were maximizing the "principal's" welfare is quite general. It exists in all organizations and in all cooperative efforts...." (309). To agency

[15]See Carlos & Nicholas (1993) for an interesting approach to measuring the costs of agency as it relates to the fur trade and Hudson's Bay Company.

theorists, the "agency problem" is solved when the interests of principal and agent are aligned through the use of the incentive system, the establishment of contractual safeguards, and monitoring agent behaviour.

First, informal venture capital appears to be what Eisenhardt (1989) refers to as a "theory-relevant" context. She argued that the potential for agency problems to arise should be particularly acute in situations where: i) the potential for substantial goal conflict between principal and agent exists; ii) a degree of uncertainty exists with respect to outcomes; and iii) the nature of the task to be undertaken is unprogrammed, that is to say it is difficult for the principal to specify how the agent is to undertake the task ex ante which, as a consequence, creates ongoing monitoring difficulties for the principal ex post. Entrepreneurial ventures would appear to be one such promising theory relevant context worthy of further consideration. Sapienza & Gupta (1994) noted that venture-capital backed firms are generally characterised by high levels of task and outcome uncertainty.

Second, contracting problems in the new venture setting are exacerbated by the presence of significant information asymmetries between the contracting parties (Barnea, Haugen & Senbet 1985). Agency theorists would argue that entrepreneurs may enjoy a number of informational advantages vis-à-vis private investors. First, entrepreneurs possess an intimate knowledge of their true skills and abilities; information which may not be made available, or imperfectly communicated, to investors[16]. Second, investors cannot oversee all of the activities of the agent all of the time. The entrepreneur thus knows more about their true effort level than the investor, although it should be noted that investors often insist upon being provided with information on a regular basis by the entrepreneur to monitor agent effort and may, as circumstances warrant, become directly involved in the venture's

[16]This observation is consistent with the view of Leland and Pyle who stated that: "Entrepreneurs usually know their own collateral, industriousness, moral character, and business prospects better than do venture capitalists." (1977: 16)

operations[17]. Third, investors may have limited knowledge of either the transformation process of the firm (Ouchi 1979) or the industry in which the venture competes.[18]

Finally, the thrust of the agency theory perspective is incentive based, exploring the mechanisms by which the decisions of agents (entrepreneurs) can be brought into closer alignment with the best interests of the principal (investor). The focus on incentives is conceptually appealing in the context of entrepreneurial ventures as all parties to the exchange maintain meaningful equity stakes in the business, thus from the start everyone has a significant interest in structuring their relationship in a manner that encourages value creation. In the absence of efficiently operating external mechanisms of control, such as effective replacement markets for entrepreneurial talent and share liquidity, one could argue that putting in place the right incentive structure from the start is a necessary prerequisite for any private equity transaction.

3.9 Limitations of the Agency Theory Perspective in the Informal Venture Capital Arena

Clearly, the agency theory perspective holds the possibility of being a particularly useful lens through which to better understand the choices faced by investors in structuring their economic relationship with the entrepreneur. One scholar (Landström 1992) called into question the very applicability of the agency theory perspective to the domain of the private investor. The appropriateness of extending the agency theory perspective in the informal venture capital field can be called into questioned on the basis of: i) the scope of empirical

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[17]Dyl (1988) provided empirical evidence to support the notion that major shareholders gain more from monitoring than smaller shareholders. Presumably, larger shareholders also have much more to "lose" from choosing not to monitor.

[18]Although it should be noted that the vast majority of private investors have had previous direct experience in the new venture setting. To the extent that "venture building skills" are viewed as generalisable to any industry setting and anecdotal evidence would suggest that this is the case, the perceived level of information asymmetry may not be as large as first thought.

studies undertaken to date; and ii) the limiting nature of the assumptions upon which agency theory is based. These issues will briefly be discussed in turn.

On balance, most of the empirical work which has relied on the agency theoretical lens has focused primarily on issues related to separation of ownership and control in large, publicly-traded companies which are often characterised by a widely dispersed shareholding structure with management retaining relatively small equity stakes (Eisenhardt 1989). Comparatively little research has been undertaken in privately-held firms in which the ownership structure is concentrated among a smaller number of parties and where management equity stakes are relatively large (Sapienza & Gupta 1994). What implications might this have for the applicability of the assumptions upon which agency theory is based?

First, the implied assumption that the role of "principal" and "agent" is fixed may not be appropriate in the context of closely held private companies. At times, when private investors take steps to increase their influence over the venture development process, they may very well bear some of the coordination costs akin to "agents" (Jensen & Meckling 1976). Similarly, as Sapienza (1989) noted: "...the significant ownership share of some entrepreneurs and their dependence on sustained capital infusions lend to them many of the concerns of principals as described in agency theory." (54) Cable and Shane (1997) also noted that the relationship between venture capital investor and entrepreneur is not hierarchical in nature and that opportunistic behaviour on the part of either can be problematic to the other.

Second, principals and agents are assumed to be motivated solely by economic self-interest or personal wealth maximisation (Baiman 1990). There is abundant evidence to suggest that both private investors (Wetzel 1981; Landström 1992; Duxbury, Haines & Riding 1994; Mason & Harrison 1994c) and entrepreneurs (Timmons 1990; Vesper 1980) are motivated by issues other than strictly maximising their own wealth. Wealth maximisation is important for both investor and entrepreneur but can not be considered as all important[19].

Third, the inherently negative assumption about human beings upon which the agency theory perspective is based, namely that agents will display a tendency to misrepresent their true abilities (adverse selection) and are prone to engage in shirking and opportunistic behaviour (moral hazard), strongly implies that there is little room for trust to prevail between the principal and agent at the time relationship is entered into. Agency theorists increasingly recognise the importance of trust and reputation effects resulting from multiple period interaction between principal and agent (Lambert 1983; Holmstrom 1979; Pratt & Zeckhauser 1986; Levinthal 1988), however, the issue of whether "disincentive effects" are created at the outset by investors wishing to protect themselves from agency risk is an unexplored issue. Relying on the prisoner's dilemma, Cable and Shane (1997) built a framework that emphasised the need for both parties to establish "bases of cooperation". Comprehensive and highly elaborate governance mechanisms designed to bring the interests of principal and agent into closer alignment may in fact have the opposite effect insofar as it could be interpreted by the agent as a powerful signal of distrust. As Sapienza & Gupta (1994) noted: "...above a certain level of ownership, there is little or no reason to expect incentive-related shirking or opportunism." (1629)

On balance, while there are reasons to believe that the agency theory perspective may be "inapplicable" to the informal venture capital arena, the area of study is, in many respects, virgin territory and largely unexplored. Notwithstanding the potential limitations noted above, the agency theory perspective appears to offer useful insights that may help to guide the future development of explanatory theories of how the informal venture capital market operates. In some respects by "testing the boundaries" of agency theory, we may help to "establish the boundaries" for the informal venture capital field, particularly in this exploratory

[19]The general point that organisations at times are motivated by goals other than strict economic efficiency has been advanced by Robins (1987) and McGuire (1988) among others.

phase of the field's development.

3.10 Placing This Study In Context: A Review of Relevant Entrepreneurial Finance Literature

In an effort to highlight the contribution of this study, we shall briefly review the received research that have relied on either transaction cost economics, agency theory or both as a basis for hypothesis development. In so doing, we shall also demonstrate how we are building upon or extending the existing base of research. It is worth noting at this point, however, that most of the empirical research that is summarised here has focused exclusively on a different market, namely the formal venture capital market. This is not altogether surprising in view of the highly visible nature of the market (participants can be identified and approached directly), the depth of understanding of the manner in which investments are structured (arising from the fiduciary responsibilities imposed on general partners in respect of limited partners) (Sahlman 1988; 1990), and the well developed networks of information dissemination among market participants (Bygrave 1987; Fiet 1991; Lerner 1994a). Having said this, the formal venture capital market differs in some fundamental ways from the informal one and so, in many respects, the phenomenon are expected to be quite distinct. The emerging consensus is that compared to venture capitalists, private investors: i) invest their own funds and thus are answerable to themselves; ii) typically invest in smaller amounts and at earlier stages of venture development; iii) bring more personal experience in the new venture setting and in business than do venture capital fund managers, particularly in Europe; and iv) are more intimately involved with the venture post-investment as compared to venture capital funds. These salient distinguishing characteristics of the informal market should be kept in mind when reviewing any research that has been undertaken in the formal venture capital sector.

Integrating the Transaction Cost and Agency Theory Perspectives

In a survey of fifty-four electronic firms which received venture capital funding, Barney, Busenitz, Fiet & Moesel (1989) maintained that in situations where the levels of business (unforeseen competitive conditions) and agency risk (possible divergence of interests between the parties) faced by investors was high, investors should hold a greater percentage of equity and a larger percentage of the board seats. They found that investors held smaller equity stakes ($p<.01$) and a smaller proportion of board seats ($p<.05$) in ventures run by CEOs with longer tenure in the business. Not surprisingly, there was a strong negative association ($p<.01$) between the investor equity stake and the amount of capital invested by the CEO. As an early stage work, this study did establish a link between the concept of risk and governance structures adopted by investors. However, the control measures that were developed - distribution of voting rights and board seats - provide limited insights into the broad variety of means that investors can choose to influence management decisions in desired ways.

In another study of venture capital backed firms, Barney, Busenitz, Fiet & Moesel (1994b) examined the determinants of the formal contractual arrangement between investor and entrepreneur. A distinction was drawn between managerial and competitive opportunism. Managerial opportunism arises in situations where principals find it difficult to monitor the activities of agents and there is a risk that the latter may take decisions that serve to diminish investor wealth. Competitive opportunism is said to exist when an entrepreneur chooses to leave a venture and compete directly with the venture; the propensity of the entrepreneur to act in such a manner, it was argued, was a direct function of the expected profit stream of the new venture. A greater number of contractual provisions were included to control managerial opportunism where the management team had worked together before for a long period of time ($p<.05$) and invested a greater percentage of their net worth into the venture ($p<.05$). Fewer restrictions controlling managerial opportunism were included where management had extensive prior experience in the new venture setting ($p<.01$) and the initial outside equity investment was relatively small ($p<.05$). Fewer limits on competitive opportunism where included if it would prove difficult to differentiate a new product offering ($p<.01$) but more restrictions were included if product obsolescence was a persistent problem ($p<.05$). These findings suggest that previous new venture experience may translate into less restrictive terms ex ante and that elaborate governance structures may not make economic sense for smaller deals. This study did provide some useful insights into why some deals are "tight" (many restrictions) or "loose" (few restrictions) in nature. However, we are not able to discern precisely "how" investors choose to control these risks in terms of the actual contractual safeguards that are included in a given deal. Moreover, one of the possible consequences from venture capital funds actively syndicating deals with one another is that there may be a tendency to converge on some commonly agreed contractual format (known in the trade as "boilerplate") (Sahlman 1988; 1990). In short, it might be difficult to find significant variation in the content of contractual deals, particularly when numerous venture capital funds are involved.

Sapienza (1989; 1992) examined the linkage between venture context, CEO traits and the level of investor involvement in the venture development process[20]. Active investor involvement was seen as a means for investors to manage inherently high levels of business risk while reducing the potential threat of opportunistic behaviour on the part of the entrepreneur. In a matched pair survey of fifty-one venture capital investor-lead entrepreneur dyads, higher levels of investor involvement were reported: i) in early stage ventures ($p<.001$); ii) in highly innovative ventures ($p<.01$); iii) where CEOs had no previous experience with start-ups ($p<.01$) or limited experience in the industry in which the venture competed ($p<.10$), iv) in ventures located in close proximity to the investor ($p<.05$); and v) where the equity stake held by the entrepreneur was relatively small as compared to the

[20]Sapienza & Timmons (1989a) identified eight roles investors play in the venture development process including: financier, business contact, industry contact, business advisor, management recruiter, sounding board, coach/mentor, and friend/confidant.

investor ($p<.05$). Sapienza's research highlighted major contextual factors underpinning the choices investors make on how to structure the ongoing relationship between themselves and entrepreneurs. Aside from providing us with a clear understanding of "when" and "how" venture capital fund managers are involved in the venture post-investment, this work highlighted the importance of the relationship that develops between the parties over time. Compared to venture capitalists, private investors do appear to be much more intimately involved in the development of the businesses that they fund, not altogether surprising given that they are typically investors for a period of time before venture capital becomes involved. Moreover, the focus of Sapienza's work is on the post-investment and not on the deal inception phase.

In a comparative study of venture capitalists and private investors, Fiet (1991, 1995a, 1995b) examined the extent to which investors relied on themselves as opposed to others for obtaining market (unforeseen competitive conditions) and agency (the possible divergence of interests between investor and entrepreneur) risk reducing information. In so doing, he compared the "transaction cost view" of economic exchange which highlights the problem of opportunism with the "social embeddedness view" espoused by Granovetter (1985) which maintains that economic exchanges are both embedded within a social network and can, through repeated exchanges, be infused with trust. According to Williamson's logic, investors should rely more on themselves than on others to gather risk agency and business risk reducing information whereas Granovetter would advocate the exact opposite. Consistent with Williamson's transaction cost view, Fiet discovered that private investors were more concerned about agency as opposed to market risk ($p<.01$), they relied much more upon themselves than others to gather agency and market risk information ($p<.01$), and that, relative to venture capitalists, private investors consider the agency risk inherent in a deal to be a much more important issue ($p<.05$). Fiet (1995b) concluded that "...the business angel strategy for avoiding risk is to substitute reliance upon a competent and trustworthy entrepreneur for their own competence in limiting losses due to market risk" (567).

Conversely, the primary preoccupation for venture capitalists was market as opposed to agency risk ($p<.01$) and fund managers often relied on information provided to them by other venture capital firms ($p<.01$). Through repeated exchanges, venture capital firms have developed a trustworthy network of close ties with other fund managers both as a source of deal flow and information (Bygrave 1987) consistent with the "social embeddedness" view espoused by Granovetter (1985). Fiet's work has served to reinforce the belief that investing one's own capital into a privately-held business is an inherently personal decision and that private investors go to great lengths to convince themselves of the merits of the proposition before committing their capital. Forming a judgement about the capabilities and intentions of the entrepreneur is a primary preoccupation of private investors but this study did not address the issue of "how" these individuals choose to control for these risks in practice.

Aside from Fiet's work, no other research in the informal venture capital field has relied on the transaction cost perspective as a basis for generating testable hypotheses. This is somewhat surprising as the perspective has an intuitive appeal in its focus on transaction attributes (the "deal") and on developing mechanisms to mitigate the impact of opportunistic behaviour on the part of the entrepreneur. Aside from the visibility of the market, the focus of attention on venture capital backed deals is understandable in view of the fiduciary responsibilities fund managers face vis-à-vis their investors (van Osnabrugge 1999). There appears to be scope for transaction cost economics to clarify our understanding of the reasons why private investors structure their relationship with the entrepreneur in the manner that they do. Having said this, one must be mindful of the possible limits of extending the perspective into a new domain characterised by necessarily incomplete contracts (van Osnabrugge 1999) and where we believe that the relationship between the parties is neither hierarchical (Cable and Shane 1997) or adversarial in nature (Granovetter 1985).

In this study, we are proposing to rely on transaction cost economics to develop a framework to understand what influences the shape and form of the contractual deal struck with the entrepreneur in the initial deal structuring phase. Second, we hope to identify the areas where greater degree of contractual clarity is sought and where ambiguity is tolerated. Third, by measuring the perceived level of trust that one party (the investor) has in another (the entrepreneur), we can assess the robustness of claims made by critics that transaction cost economics is "under-socialized" (Granovetter 1985).

The Agency Theory Perspective and Entrepreneurial Ventures

Within the context of agency theory, the role of venture capitalists and private investors is subtly different albeit both groups tend to rely on similar processes and criteria for making investment decisions (Riding, Duxbury & Haines 1994). Venture capitalists, being the "custodians of other people's money", assume the role of agent with respect to their relationship with fund investors while at the same time assuming the role of principal with respect to the entrepreneurs which receive financial backing (Sahlman 1990). Conversely, by investing their own funds, private investors are answerable only to themselves, and thus do not face the sometimes conflicting demands arising from being concurrently a principal and agent in their relationships with providers (themselves) and users (entrepreneur) of capital (van Osnabrugge 1999). For purposes of exposition, it is useful to discuss the research findings of the formal and informal segments of the market for venture capital separately.

Formal Venture Capital

In his comprehensive study of the structure of venture capital fund governance mechanisms, Sahlman (1990) concluded that: "The venture capital industry has evolved operating procedures and contracting practices that are well adapted to environments characterised by uncertainty and information asymmetries between principals and agents" (473). In view of the level of syndication among participants in the formal venture capital market (Bygrave 1987; Lerner 1994a), it is not surprising to see similar contractual responses to deal with agency risk by: i) providing funds in tranches[21]; ii) investing by way of preferred shares[22]; iii) becoming actively involved in many aspects of the venture's operations; iv) employing the use of ratchets[23]; v) working on the board of directors; vi) requiring a regular flow of information from the entrepreneur; and vii) applying high discount rates, thereby reducing the price paid for a given equity stake, to compensate for inherent agency risk (Sahlman 1988; 1990). While providing an excellent overview of how venture capitalists structure deals, this study did not examine in detail the underlying factors that influence decisions as to what contractual safeguards investors include and the form and intensity of their involvement with the venture post investment for specific deals.

Building on Jensen & Meckling's (1976) notion that the financial interests of principals and agents diverge as the equity stakes held by the latter fall, Sapienza & Gupta (1994) tested the notions that agency problems can also arise as a result of: i) lack of agent ability[24]; and ii) genuine disagreements between the parties as to the direction of the agent's effort particularly in the new venture context which is often characterised by high levels of task uncertainty[25]. Monitoring efforts by the principals, conceptualised as frequency of interaction,

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[21]In so doing, the venture capitalist preserves the right to abandon the project entirely and/or the ability to make a more fully informed estimation of the value of the venture at particular times in the venture development process.

[22]Berglöf (1994) developed a control theory of venture capital finance which provides an explanation for the predominant use of preferred stock and convertible debt instruments by venture capitalists. Conversion rights can provide investors the means to secure voting control in the event of venture performance deterioration.

[23]The equity stake of the entrepreneur is periodically adjusted upwards or downwards based on their ability to meet prescribed performance targets established by the investor.

[24]This extension can first be attributed to Walsh & Seward (1990). Managerial ability is a central concern of venture capitalists during the due diligence phase (Hisrich & Jankowicz 1990; Rock 1991; Ruhnka & Young 1991).

[25]Bruton, Fried & Hisrich (1995) asked sixty-eight venture capital investors to identify the reasons for the dismissal of the CEO in a particular instance. Almost half the respondents

was reported to be higher in situations where: i) the level of goal congruence between lead investor and CEO was low ($p<.05$); ii) the CEO had little previous start-up experience ($p<.05$); and iii) the venture was in the early stages of development ($p<.05$) and highly innovative in nature ($p<.10$). Interestingly, they did not find support for the hypothesis that frequency of interaction was negatively related to agent equity ownership share. The authors concluded: "...that process responses (to governance challenges) do indeed supplement structural mechanisms.... In new ventures, such process responses may be particularly salient because a high level of management ownership may render tinkering with incentive mechanisms ineffectual and the idiosyncratic knowledge possessed by the ventures' founders and other top managers may be virtually irreplaceable." (1629). Beyond a certain point, the authors imply, more constrictive rules, procedures and safeguards may do no more harm to the relationship between entrepreneur and investor than good. While acknowledging that governance involves both process (involvement) and structural (contractual safeguards and relative equity stakes) dimensions, this study was restricted to the former thus implying a focus on the post-investment phase only.

Sapienza, Manigart & Vermeir (1995) conducted a four country study of venture capitalists in the US, UK, France and the Netherlands to determine under what circumstances investors were inclined to initiate more face-to-face contact with ventures as means of dealing with agency risk. Generally, they reported higher levels of interaction the shorter the period of time the investment was in the investor's portfolio in the US and France. Contrary to expectations, French and Dutch venture capitalists interacted more intensively with CEOs who had higher levels of experience in the industry and new venture setting. Uniformly across all countries, investors interacted more with early as opposed to later stage ventures. As with Sapienza's earlier work, the focus of this study is restricted to understanding the factors that influence the level of investor involvement with the venture post-investment.

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cited lack of agent ability and over a quarter of the dismissals were attributed to differences in opinion between investors and entrepreneurs as to the future direction of the venture lending support to the extensions proposed by Sapienza & Gupta (1994).

Compared to private investors, van Osnabrugge (1999) concluded that venture capital fund managers place greater emphasis on the care, time and attention taken in the investment screening stages to craft an "optimal" contract. In an effort to demonstrate and signal their competence to their fund providers, venture capital fund managers appear to adopt what van Osnabrugge describes as a "principal-agent approach". He found that venture capital funds devoted more effort and resources to due diligence, exercised a greater degree of contractual control and were more concerned about exit provisions than were the private investors he surveyed. This highly meticulous and methodical approach to structuring investments ex ante appears to be driven by the perceived demands of fund providers who need assurance that their capital is invested in a demonstrably prudent manner. While providing an invaluable overview of the contrasting approaches used by venture capitalists and private investors, the study did not collect data on individual investments nor on the specific contractual safeguards that were included up front.

The process through which venture capitalists identify, evaluate and decide which ventures to back and on what terms is reasonably well understood. In general, agency risk seems to be problematic in early stage ventures run by teams that have little industry and/or new venture experience. Venture capitalists appear to supplement contractual safeguards with "process responses" to governance challenges (Sapienza & Gupta 1994) through active involvement in a number of different roles in the venture development process. There has been some progress in terms of determining the influence of context on the choices that are made in deciding which provisions to include in the contractual deal (Barney, Busenitz, Fiet & Moesel 1994b) although one may reasonably expect that given the public visibility of the formal venture capital market coupled with the extensive syndication that occurs among participants (Bygrave 1987), the form of contracts between venture capital firms would converge into a common format, commonly referred to in the trade as "boilerplate". Market invisibility in the informal venture capital market presents its own challenges and it is to these that we now turn.

Informal Venture Capital

Freear & Wetzel (1992) in their review of the state of entrepreneurship research in the informal venture capital area called for more theoretically grounded empirical work with the aim of enhancing our level of understanding of how investment decisions are made and the underlying market dynamics in operation. To date, a small number of studies have relied on the agency theory perspective to examine a wide variety of different issues including the decision process used by private investors (Riding, Duxbury & Haines 1994, van Osnabrugge 1999); the relative importance investors attribute to agency versus market or business risk (Fiet 1995b); the extent to which investors rely on the advice provided to them by others during the due diligence phase (Fiet 1995a) and issues related to post-investment monitoring and control (Landström 1992). Aside from Fiet's work, which has been summarised above, what has been learned from these studies?

In their large scale survey of Canadian private investors, Riding, Duxbury & Haines (1994) found that investor dependence on referrals from trusted business associates serves to act as a first filter for the adverse selection problem of deciding which entrepreneurs to back. Mindful of their reputations, these close associates exercise a degree of caution in determining which opportunities to bring to the attention of their trusted colleagues. Once the decision to invest is made, almost 90% of the respondents expected representation on the board of directors. An equal number of investors required a contractual shareholder's agreement, which in 70% of the cases also included restrictive operating covenants. The authors conclude that investors protect themselves from moral hazard through active involvement in the venture development process as well as by insisting upon contractual safeguards ex ante. While highlighting the important and informative screening role deal referrers can have and the various strategies by which investors seek to manage risk and promote their interests as shareholders, several outstanding issues remain. Which contractual safeguards are incorporated into the deal and why? When do investors become involved and in what form does this involvement take?

Landström (1992) surveyed sixty-two Swedish manufacturing and technology-based firms that received funding from private investors. Working under the assumption that private investors attempt to manage agency risk through the level of their involvement in the venture's operations, he hypothesised that investors would be more involved in ventures that were: i) highly innovative; ii) early stage; iii) operating in turbulent environments; iv) managed by inexperienced entrepreneurs with lower equity stakes in the venture; v) located close to the investor's home base of operations; and vi) competing in an industry familiar to the investor. The only significant results obtained were in support of the hypotheses of geographic proximity ($p<.05$) and investor knowledge of the transformation process ($p<.01$). In interpreting the findings, Landström concluded that: "...it is not the required level of control which is most influential in determining the frequency of contracts and (level of) operational work. It is rather the feasibility for active involvement that seems to be most influential...." (216) He calls into question the assumption that private investors and entrepreneurs alike behave in a rational economic maximising fashion as agency theory would suggest. Moreover, the objective function of agency theorists - curb opportunistic behaviour - is inherently negative in tone. Landström concluded that: "The relationship between the private investor and entrepreneur has a more positive character, where the interaction (between the parties) is based on support and mutual trust." (218). Rather than rely on monitoring controls, he implies that the development of a personal relationship based on trust might be an effective substitute for establishing elaborate monitoring systems and/or contractual safeguards as a means of influencing agent behaviour. Building on Sapienza's work in the formal venture capital market, Landström's study has served to highlight the different character of the informal venture capital market but, again the focus is on one form of governance (process) as opposed to another (structure) in the post-investment phase only.

Van Osnabrugge (1999) found support for the notion that compared to venture capital fund managers, private investors work from a notion that contracts between themselves and the entrepreneur are necessarily incomplete (the "incomplete contracts approach"). For them, control over the entrepreneur's behaviour and the venture's development is best achieved through being actively involved in the venture post investment as opposed to devoting undo time, attention and detail to crafting a comprehensive contract ex ante (the "principal-agent approach"). The distinction to be drawn between the two approaches is a fine one as a degree of contractual specificity is implied by each albeit the relative emphasis placed on certain activities by venture capitalists and private investors do differ. The research design employed did not collect data on individual investments nor on specific traits of the contracting parties involved thus it was not possible to draw out contextual influences on the decision-making process and approach used by a specific investor towards a specific investment.

It is the characteristics of the informal venture capital market itself that has attracted growing interest among researchers as an interesting domain in which to put agency theory "to the test". Private investors often "transact" in situations of great task and outcome uncertainty, where information is asymmetrically distributed between the parties, and where external control mechanisms are weak if not non-existent (Walsh and Seward 1990). From the few studies which have relied on the agency theoretical perspective to develop testable hypotheses, it would appear that private investors: i) are concerned about agency risk, ii) rely on themselves to evaluate the qualities of the agent, iii) build in contractual provisions ex ante to protect themselves from opportunistic agent behaviour, iv) exercise influence through board membership, and v) work very closely with ventures that compete in a domain in which the investor has experience and that are located in close proximity to the investor's home base of operation. Having said this, a great deal of care needs to be taken in relying on agency theory as a theoretical underpinning as the relationship between the parties to the exchange appears to be neither necessarily hierarchical (Cable and Shane 1997) nor adversarial (Landström 1992) in nature. Moreover, van Osnabrugge (1999) highlighted potential differences in the manner in which private investors and venture capitalists approach the task of "doing deals".

In this study, we are proposing to build upon the base of existing research in a number of ways. First, by collecting detailed information about specific deals, we are able to document the nature of the co-operative solutions adopted and, more importantly, speculate as to the reasons for their structure (Cable and Shane 1997). Second, by concentrating our attention on the initial deal-structuring phase, we may be able to identify links to research that has focussed on the post-investment relationship that develops between the parties (Landström 1992). Third, by exploring the linkages between contextual factors and governance choices, we also hope to be able to build upon van Osnabrugge's work to discover why contractual arrangements differ and the underlying motivations for investor involvement in the venture post investment.

3.10 Conclusion

The transaction cost economics and agency theory perspectives are different yet highly complementary ways to examine how contextual factors shape the choices that boundedly rational parties make in structuring their exchange relationship. In a sense the intuitive appeal of both perspectives is the recognition that creating a degree of transparency and integrity in economic relationships is a significant challenge, particularly in situations where there is task uncertainty and the linkages between behaviours and outcomes can not be established with certainty. In trying to establish a framework that promotes the mutual interests of all parties to the exchange, both perspectives look to contractual safeguards, monitoring and the structure of the incentive system as key design variables that can be manipulated. In choosing how best to structure a given economic relationship, both perspectives highlight the importance of both transaction characteristics and transactor attributes.

Much of the received research in the field of entrepreneurial finance that has relied on either or both of these theoretical lenses as a basis for developing testable hypotheses and models has been undertaken in the formal venture capital market. Market visibility has greatly facilitated the ability of researchers to identify potential respondents and assess the representativeness of their samples. Moreover, there is reason to believe that fund managers pay scrupulous attention to deal-structuring in an effort to demonstrate their competence to and satisfy the fiduciary obligations imposed on them by their limited partners (van Osnabrugge 1999). By design, venture capitalists are both principals in their relationship with the entrepreneur and agents in their relationship with fund investors. These competing demands perhaps explain why fund managers approach the task of deal structuring in a very meticulous and methodical fashion (van Osnabrugge 1999).

Although venture capitalists and private investors both take equity stakes in privately and closely held businesses, the informal venture capital market differs in some fundamental ways from the formal one. First, private investors place their own funds at risk and are under no pressure from others "to invest" (Benjamin and Margulis 1996). Second, private investors usually invest in smaller amounts and at earlier stages of development than do venture capital funds. Third, unlike most European venture capital fund managers, private investors often bring personal experience building businesses of their own. The differing investment focus and backgrounds of transactors may go some way to explain the findings of van Osnabrugge (1999) who found significant differences in the manner in which venture capitalists and private investors approach the task of deal-structuring.

There is a small but growing body of research that have used transaction cost economics and/or agency theory as a basis for hypothesis development in the domain of informal venture capital. For the most part, these studies have focussed on how private investors have approached the task of due diligence and deal structuring (Fiet 1991, 1995a, 1995b; Riding, Duxbury and Haines 1994; van Osnabrugge 1998a, 1998b, 1999) or the motives for close investor involvement in the venture post investment (Landström 1992). To date, there has been no research undertaken to understand how contextual factors shape the choices investors make as to how to structure their relationship with the entrepreneur *on a deal specific basis*. Focussing on traits of "transactions" and "transactors" and exploring the influence these factors may have on relationship structure resonates strongly with the central thrust of both theoretical perspectives.

In deciding to employ these theoretical lenses into the domain of informal venture capital, we must be mindful of some potential limitations that may call into question their utility. First, both perspectives focussed on the problems associated with inducing managers who retained relatively small equity stakes in publicly-traded companies to act in accordance with the best interests of outside investors. Second, given the highly asset specific nature of the transactors coupled with the lack of efficient replacement markets (Cable and Shane 1997) and external control mechanisms (Walsh and Seward 1990), the relationship between investor and entrepreneur appears to be co-operation as opposed to protection-based (Landström 1992).

These limitations notwithstanding, there is merit in "testing the limits" of both transaction cost economics and agency theory. In so doing, we may begin to establish some theoretical boundaries on our "own ignorance" of the informal venture capital phenomenon (Wetzel 1994). In the chapter that follows, we will develop a model relying on the transaction cost economics and agency theory perspectives as a basis for advancing a number of hypotheses to explain the linkages between contextual factors and the dependent variable, what we will term "governance effort". We shall revisit the issue of the "applicability" of these theoretical lenses in the domain of informal venture capital in chapter 7. It is to the issue of model development that we now turn.

CHAPTER 4: CONTEXTUAL INFLUENCES ON GOVERNANCE EFFORT: A MODEL AND HYPOTHESES

4.0 Introduction

On the face of it, private investors face considerable governance challenges when they choose to invest their own funds into privately-held ventures often in the early stages of development and managed by an entrepreneur or team with little previous direct experience in the new venture setting (Dunkelberg and Cooper 1982; Cooper, Dunkelberg and Furata 1985; Cooper, Dunkelberg and Woo 1988). Private investors deal with these challenges in a number of ways by: i) requiring that a shareholder's agreement be signed by all parties at the time the investment is made; ii) actively working on the board of directors; iii) providing advice and guidance to the management team as required; and/or iv) working directly in the venture on a full or part-time basis (Mason, Harrison and Allen 1995, Harrison and Mason 1992b). Aside from being a key non-financial motive for investment, active involvement in the venture development process can be viewed as a governance process in its own right (Sapienza 1989; 1992); a means by which investors seek to protect their interests while at the same time affording the entrepreneur the opportunity to create value for the economic benefit of both parties.

The focus of this study is restricted to the formative stages of the relationship that develops between investor and entrepreneur, namely the period leading up to and including the signing of a shareholder's agreement. A basic premise of this study is that contextual factors shape and influence the decisions that investors make with respect to determining how best to structure their relationship with the entrepreneur. Striking an appropriate balance between the investor's need to "protect their investment" and the entrepreneur's strongly held perceived need to "protect their autonomy" (Brockhaus 1982) is a delicate task; one that can have ramifications for the future relationship that develops between the two parties.

As argued in the previous chapter, the transaction cost and agency perspectives are different, yet complementary theoretical approaches which can shed light on the linkages that exist between contextual factors and the choices investors make as to how best to structure their economic relationship with the entrepreneur. Both perspectives advocate the use of contractual safeguards and monitoring to ensure that entrepreneurs ("agents") act in the best interests of investors ("principals") and both consider the board of directors to be a key structural mechanism to influence the behaviour of management in desired ways. The relative emphasis of each perspective in terms of how best to adapt to changed circumstances is different, however. From the transaction cost perspective, flexibility is best incorporated ex ante through the inclusion of a dispute resolution mechanism in the shareholder's agreement whereas the agency perspective relies, to a great extent, on the incentive system to "solve the adaptation problem" ex post.

The dependent variable of interest in this study, governance effort, is measured in two distinct ways: i) by focusing on the nature of the contractual deal which is struck with the entrepreneur ex ante (CONTRACT); and ii) the anticipated level of investor interaction with the venture ex post (CONTACT). In this chapter, we will: i) present a model of the linkages that exist between contextual factors and our two measures of governance effort; and ii) develop a series of hypotheses relying on either or both the transaction cost and agency perspectives as a basis for empirically testing the model. A fuller discussion of how we operationalised variables will be deferred until the next chapter. We now turn our attention to the issue of model development.

4.1 A Model of Contextual Influences on Investor Governance Effort

As presented in Exhibit 4.1, we maintain that investor governance effort is influenced by: i) the background experience of the contracting parties in the new venture setting, in a relevant industry and in general management positions; ii) the investor's experience as an investor in entrepreneurial ventures; and iii) specific attributes of the investment itself. Each of these elements of the model will be discussed in detail in the section that follows. In order not to confound subsequent analysis, two control variables were introduced: i) venture stage of development (STAGE), and ii) geographical proximity of the venture to the investor (DISTANCE).

In Chapter 3, we argued that governance challenges exist because it is simply not possible to anticipate and incorporate all future contingencies into a contract ex ante (Hart 1995). Opportunism can be problematic in situations where a high degree of uncertainty exists about: i) the true level of skills and experience of the contracting parties; ii) the transformation process used by the firm; and iii) the causal linkages between individual efforts and outcomes. Moreover, backing an entrepreneur can be viewed as a highly asset specific transaction, a situation that should pose inherent governance challenges for investors (Williamson 1979). The focus of this study is on the formative period of the relationship that develops between investor and entrepreneur up to and including the execution of a shareholder's agreement. It is a basic premise of this study that it is the presence of information asymmetries between the parties which creates conditions of uncertainty and, as a result, governance challenges for investors (Barnea, Haugen and Senbet 1985; Binks, Ennew and Reed 1993, Levinthal 1988, Oviatt 1988; Jensen and Meckling 1976; Landström, Manigart, Mason and Sapienza 1998).

The transaction cost and agency perspectives maintain that governance challenges can be addressed by including contractual safeguards in the shareholder's agreement ex ante and/or by monitoring agent effort on an ongoing basis. A high degree of specificity is implied in the transaction cost perspective, even with respect to the manner in which future disputes are resolved, as compared to the agency approach which relies on an appropriately designed incentive system to incorporate the necessary degree of flexibility to adapt to change. In this study, "governance effort" is a multi-dimensional construct based on measures of: i) the contractual provisions included as part of the shareholder's agreement[1] ex ante; and ii) the level of anticipated investor interaction with the venture ex post. We would maintain that the time, care and attention to specifying contractual safeguards up front and the anticipated intensity of investor contact with the venture is a direct function of the magnitude of the governance challenge faced by investors with respect to a *particular investment.* Specifying the conditions in which investors face "governance challenges" is the issue to which we now turn.

4.2 Identifying Sources of Governance Challenge

We would argue that governance challenges for investors occurs in situations where relatively high levels of uncertainty prevail. In a general sense, we maintain that there are two major sources of uncertainty: i) incomplete knowledge on the part of investors and/or entrepreneurs of the firm transformation process; and ii) incomplete knowledge on the part of investors of how to structure and manage an investment in a privately-held company. In addition, we would maintain that specific attributes of the investment itself influence the choices investors make with respect to how their relationship with the entrepreneur is structured. Each of these elements of the model will be discussed in turn.

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[1]A list of provisions was developed based on the reference work of McCaw (1994; 1995). This list was, in turn, reviewed by a number of serial investors surveyed by Kelly and Hay (1996b) and law firms that are involved in the documenting of investment on behalf of private companies for amendments as deemed appropriate.

4.3 Knowledge of the Transformation Process

As a practical matter, boundedly rational individuals can not know with accuracy and certainty how value is created in any business, be it a new venture or an established firm. A substantial stream of literature in the entrepreneurship field have tried to establish links between various attributes (or "entrepreneurial traits" as they are known in the field) and subsequent venture performance. While no consensus has been reached in terms of the type of experience that matters most in building an entrepreneurial venture, three major themes have been consistently cited in the literature which seem to "improve the odds" measurably: i) previous experience in the new venture setting; ii) relevant industry experience; and iii) previous general management experience. On the face of it, focusing attention on these three areas is thoroughly consistent with the emphasis investors place during due diligence on assessing the quality, experience and determination of the entrepreneur and/or top management team (Harrison and Mason 1992, Mason and Harrison 1994c, MacMillan, Siegel and Subbanarashima 1985). Each of these themes will be discussed in turn and hypotheses advanced relying on the transaction cost and/or agency perspective as appropriate.

i) Previous Experience in the New Venture Setting

The Entrepreneur Perspective

On balance, when an entrepreneur or top management team has previous experience in the new venture setting, a positive impact on venture performance is observed (Roure and Maidique 1986; Duchesneau and Gartner 1988; Dunkelberg, Cooper, Woo and Dennis 1987; Stuart and Abetti 1990; Tyebjee and Bruno 1984b) and product development time is shortened (Van de Ven, Hudson and Schroeder 1984; Eisenhardt and Schoonhoven 1990). It should be noted, however, that a number of studies have reported no relationship between new venture experience and sales performance (Doutriaux and Simyar 1987), firm success

(Sandberg and Hofer 1986) or survival (Reynolds and Miller 1989).

The Investor Perspective

Received research clearly demonstrates that the vast majority of private investors, usually 80% or more, have direct experience in the new venture setting (Wetzel 1981; Sullivan 1991; Short and Riding 1989; Mason, Harrison and Chaloner 1991; Stevenson and Coveney 1994; Landström 1993). In an influential study of the patterns of business development over time, Churchill and Lewis (1983) maintained that ventures develop in predictable ways and encounter similar pitfalls along the way. The implication of this study is that the skills and experience investors gain in building their own venture might be usefully applied or generalised to other entrepreneurial ventures. Whether this experience positively impacts subsequent venture performance remains an open issue for further research.

Implications for Governance Effort

Mindful of the fact that the investor makes the final decision as to whether to invest and on what terms, we need to identify situations where opportunism is most likely to be problematic from their perspective. The following table summarises the various possibilities in the form of a two-by-two matrix:

Table 4.1 – New Venture Experience Across the Investor-Entrepreneur Interface

Previous New Venture Experience	**Investor Low**	**Investor High**
Entrepreneur Low	Ignorance	Engagement
Entrepreneur High	Protection	Parsimony

We would argue that the propensity for an entrepreneur to engage in opportunistic behaviour would be highest in situations where the degree of information asymmetry between them and the investor(s) is greatest. In this instance, where an investor brings limited and the entrepreneur extensive previous experience in the new venture setting, the degree of information asymmetry between the parties is greater, and the transaction cost and agency perspective would advocate that investors protect themselves from potential opportunism by building in contractual safeguards and establishing extensive monitoring mechanisms ex ante, what we have termed "**protection**". Opportunism is problematic here insofar as the entrepreneur can take decisions, which may not be strictly in the best interest of investors, on the basis of his intimate knowledge of how to build new ventures. In the perception of the entrepreneur, the investor may be considered to be ill-equipped to question the "wisdom" of these decisions and, in many respects, the investor is heavily reliant on the experience of the entrepreneur to "do the right thing". Motivated by the need to protect their interests, investors should, consistent with both the transaction cost and agency perspectives, devote a great deal of effort in specifying the rights and obligations of both parties in contractual form and be actively involved with the venture ex post.

Information asymmetry between the parties also exists in situations where the investor brings a great deal of personal experience building new businesses but the entrepreneur does not. In this situation, it seems reasonable to suggest that it is more difficult for the entrepreneur to engage in opportunistic behaviour as the new venture setting is much more familiar terrain for the investor. Opportunism on the part of investors may be problematic for the entrepreneur who can be considered, in some measure, to be dependent on their more experienced backer for advice and guidance.[2] "Entrepreneurs turned investors" may also be better positioned to focus their attention on the critical issues to clarify in the contractual deal struck up front *and* the most effective means of imparting their "new venture knowledge" for the benefit of the venture's development ex post. The anticipated level of interaction with the venture then becomes a function of venture need rather than being motivated strictly by a desire on the part of investors to protect their interests.[3] The term "**engagement**" implies that relatively more time is devoted to "hands on" investor involvement in the venture development process and a contractual deal is developed that focuses on selected issues.

In situations where both the entrepreneur and the investor have previous experience in the new venture setting, one may reasonably expect greater clarity in the minds of both parties as to both "ends" (where to go) and "means" (how to get there). Consistent with the growing literature which models reputation effects (Lambert 1983; Holmstrom 1979; Levinthal 1988), experienced entrepreneurs are well positioned to negotiate more favourable contractual terms ex ante with investors. Moreover, they may be better able to define venture development needs and thus know what type of assistance they want from investors and when such assistance is required. "**Parsimony**" implies a spirit of much more focused effort on the part of the investor both in terms of the nature of the contractual deal agreed to up front and the anticipated level of monitoring ex post.

Where both parties have limited previous new venture experience, both the investor and the entrepreneur find themselves in very unfamiliar terrain. In essence, they must develop a structure for their economic relationship based from a position of relative "**ignorance**" of the issues and challenges they will face in the future. In the absence of knowing where potential pitfalls and challenges lay in the process of developing a new venture, the contractual deals that are struck between two inexperienced parties might be very simple indeed. Moreover, the entrepreneur may be ill-equipped to define the venture's development needs and, for that matter, the investor ill-equipped to effectively deal with them in any event.

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[2] Consistent with the transaction cost and agency perspectives, the entrepreneur may push for more contractual specificity up front.

[3] It should be noted, however, that the distinction to be drawn between protecting one's interests and promoting one's interests is not altogether clear.

Governance challenges thus appear to be a function of the relative distribution of task experience among the contracting parties, an observation consistent with Williamson's view that governance structures reflect, in some way, the underlying experience base of the contracting parties. The focus of our study is on understanding how one party, investors, deal with these challenges. For them, opportunism is most problematic in situations where the relative distribution of task experience favours the entrepreneur. It follows that:

H1a: The greater the level of new venture experience of the entrepreneur/team relative to the investor(s), the greater is the potential for opportunism to occur, the more comprehensive the contractual safeguards built in by investors ex ante.

H1b: The greater the level of new venture experience of the entrepreneur/team relative to the investor(s), the greater is the potential for opportunism to occur, the more intensive the anticipated level of investor contact with the venture ex post.

ii) Previous Relevant Industry Experience

The Entrepreneur Perspective

Similar to the argument advanced above with respect to new venture experience, received research would, on balance, support the view that previous experience in a relevant industry appears to positively influence venture performance (Roure and Maidique 1986; Teach, Tarpley and Schwartz 1986; Dunkelberg, Cooper, Woo and Dennis 1987; Stuart and Abetti 1987, 1990; Tyebjee and Bruno 1984b; Chandler and Hanks 1991; Neiswander and Drollinger 1986). It should be noted, however, that three studies (MacMillan, Zemann and Subbanarashima 1987; Sandberg and Hofer 1986; Van de Ven, Hudson and Schroeder 1984) reported no significant relationship between industry experience and subsequent venture performance.

The Investor Perspective

Private investors prefer to invest in situations where they can contribute directly to the development of the venture (Harrison and Mason 1992b: Rosenstein, Bruno, Bygrave and Taylor 1989). Aside from new venture and general management experience, some investors bring extensive previous experience in the industry in which the venture competes. Detailed knowledge of the firm's transformation process (Ouchi 1979), suppliers and customers not only enhances the ability of the investor(s) to evaluate the opportunity during the due diligence phase, but can prove to be particularly beneficial to the venture's subsequent growth and development.

Implications for Governance Effort

From the vantage point of the investor, the situation which should cause the most concern in terms of the potential for opportunism to occur is when the entrepreneur/team bring much more relevant industry experience to bear than does the investor(s). Again, it is useful to highlight the various possibilities in tabular form as a two-by-two matrix.

Table 4.2 – Relevant Industry Experience Across the Investor-Entrepreneur Interface

Previous Industry Experience	**Investor Low**	**Investor High**
Entrepreneur Low	Shot in the Dark	Back Seat Driver
Entrepreneur High	Protection	Selective Intervention

In situations where an entrepreneur brings extensive previous relevant industry experience and the investor does not, the potential for an entrepreneur to strategically withhold or misrepresent key information and/or behave in an opportunistic manner vis-à-vis the investor may be quite high. It is conceivable that decisions may be taken by management based on "specialised industry knowledge" that are not strictly in the best interests of the investor; decisions which the investor may be ill-equipped to question and/or influence in any way, reliant as they are on the experienced entrepreneur for input. Faced with these risks, the transaction cost and agency theory perspectives would advocate that investors should incorporate contractual safeguards in the shareholder's agreement and monitor the progress of the venture closely, what we have termed "**protection**" in Table 4.2.

Where both parties have extensive relevant previous industry experience, it seems reasonable to suggest that it would be very difficult for the entrepreneur to withhold or misrepresent information to an investor who is thoroughly familiar with the industry in which the venture competes. Potential opportunism is "checked" by reputation effects operating on both sides of the investor-entrepreneur dyad. To the extent that investors value "experience", entrepreneurs may be better placed to negotiate more favourable contractual terms ex ante and have a clearer idea of what the venture's needs are, thereby clarifying the role of the investor in the development process ex post. The term "**selective intervention**" imparts a sense that investors give management a great deal of operating latitude day-to-day but that on selected issues the input of investors is sought out by the entrepreneur.

Previous research has confirmed that industry experience appears to be a necessary prerequisite to the decision to invest. It is highly unlikely that investor(s) will back propositions from an entrepreneur who brings little or no relevant industry experience to the table. To the extent that neither party has previous relevant industry experience, such investments can be regarded as a "**shot in the dark**". Moreover, entrepreneurs would appear to be at the mercy of investors where the latter brings extensive industry experience to bear on the venture and the entrepreneur does not; the latter, in this instance is relegated to the role of being a "**back seat driver**", in effect, an employee of an investor who is intimately involved in every detail of the venture's operation.

Consistent with the line of reasoning advanced with respect to relative experience of the contracting parties in the new venture setting, potential opportunism is most problematic for investors in situations where the relative distribution of task experience favours the entrepreneur. It follows that:

H2a: The greater the level of relevant industry experience of the entrepreneur/team relative to investor(s), the greater is the potential for opportunism to occur, the more comprehensive the contractual safeguards built in by investors ex ante.

H2b: The greater the level of relevant industry experience of the entrepreneur/team relative to investor(s), the greater is the potential for opportunism to occur, the more intensive the anticipated level of investor contact with the venture ex post.

iii) General Management Experience

The Entrepreneur Perspective

Breadth of experience has generally been shown to be a positive influence on venture performance (Duchesneau and Gartner 1988; Gartner 1984; Stuart and Abetti 1987, 1990). In fact, Stuart and Abetti (1990) concluded that years of experience in management positions within entrepreneurial firms was their single strongest positive indicator of performance. One obvious way to achieve breadth of experience is through the formation of a balanced team of individuals to drive the venture development process forward. Where a team has worked extensively together before, positive relationships have been shown with respect to firm success (Roure and Maidique 1986) and the speed with which products are introduced to market (Eisenhardt and Schoonhoven 1990).

The Investor Perspective

Numerous studies have highlighted the importance investors attach to having a balanced and experienced management team in place to spearhead the venture development process (Harrison and Mason 1992; Mason and Harrison 1994c; MacMillan, Siegel and Subbanarashima 1985, Vesper 1980; Roure and Maidique 1986). Breadth and depth of experience are key criteria upon which a given investment is evaluated by investors[4]. In view of the fact that most private investors bring a wealth of general business experience to the table, in addition to capital, one can argue that they are reasonably well qualified to judge the calibre of management and the quality, depth and relevance of their business experience.

Implications for Governance Effort

Again, it is useful to visualise potentially problematic situations for opportunistic behaviour to occur in tabular form as a two-by-two matrix:

Table 4.3 – General Management Experience Across Investor-Entrepreneur Interface

General Management Experience	**Investor Low**	**Investor High**
Entrepreneur Low	Blind Leading Blind	Mentor Partner
Entrepreneur High	Silent Partner	Business Partner

From the standpoint of the investor, the situation that would pose the greatest threat of opportunism is where they have little or no general management experience and they are

[4]Lack of confidence in management was a major contributing factor in the decision not to invest in studies by Riding and Short (1987b), Riding (1995), Bruno and Tyebjee

backing a highly experienced entrepreneur or team. With limited practical experience managing businesses, entrepreneurs may see little practical merit in consulting investors on these matters. Moreover, investors may feel ill-equipped to "question management" as inexperienced as they are in general management positions. Experienced business people are better positioned to negotiate from a position of strength and thus, may be able to negotiate more favourable terms with investors inexperienced in the ways of business. The term "**silent partner**" implies that the entrepreneur may want the investor's cash and as few intrusions and obstructions as possible. To curb the potential for opportunism to occur, however, silent partners must be able to protect their rights by including both contractual safeguards and insisting upon monitoring rights. Consistent with the transaction cost and agency theory perspectives, investors would want to develop a structure that asserts their rights vis-à-vis the entrepreneur in spite of possible objections raised from more experienced entrepreneurs.

Information asymmetry between the parties is also high where the relative balance of general management experience is skewed in favour of the investor. For investors, the potential for opportunistic behaviour on the part of the entrepreneur to occur may be quite low thereby mitigating the need to build in elaborate contractual safeguards up front. Entrepreneurs, however, may very well insist on specifying each party's rights and obligations in greater detail as they are dealing with a contracting partner much more experienced in the ways of business than themselves. The anticipated level of investor involvement with the venture again would appear to be a function of venture need as opposed to being motivated strictly by the need for investors to protect their interests. In many respects, the role of the investor is one of being a **"mentor partner"** for the entrepreneur.

Where both parties bring a wealth of previous business experience, the relationship between them can best be described as a "**business partner**". Reputation effects on both sides of

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(1983), and Mason and Harrison (1994a).

the investor-entrepreneur dyad act as an effective "check" on opportunistic behaviour. Entrepreneurs would not want to act in a way that could be potentially damaging to their reputation. Moreover, the ability of an investor to detect opportunistic behaviour may be significantly enhanced when that individual has extensive previous general management experience. Experienced contractors can be expected to focus on certain key issues in the contractual deal and have clear ideas of what the venture's development needs are and how to address them in the most effective manner.

Where both parties have limited previous general management experience, it is highly unlikely that the investor has something to contribute or, for that matter, that the entrepreneur realises what the venture's development needs actually are. In such a situation, opportunism may not be as much of a problem as the inexperience factor, namely that neither investor or entrepreneur have a base of general management experience upon which to rely. The term "**blind-leading-the-blind**" appropriately describes situations where both contracting parties are operating in unfamiliar terrain.

Consistent with the line of reasoning advanced with respect to new venture and relevant industry experience, governance challenges appear to be a function of the relative distribution of task experience among the contracting parties. For investors, opportunism is most problematic in situations where the relative distribution of task experience favours the entrepreneur. It follows that:

H3a: The greater the level of general management experience of the entrepreneur/team relative to that of investor(s), the greater is the potential for opportunism to occur, the more comprehensive the contractual safeguards built in by investors ex ante.

H3b: The greater the level of general management experience of the entrepreneur/team relative to that of investor(s), the greater is the potential for opportunism to occur, the more intensive the anticipated level of investor contact with the venture ex post.

4.4 Investor Related Variables

Experience as an Investor

It seems reasonable to suggest that, as with any other activity, an investor can "learn by doing" (Norton 1995; Ruhnka, Feldman & Dean 1992; Landström, Manigart, Mason & Sapienza 1998). Through evaluating and completing numerous investments, an individual can develop a keen "sense of smell" for promising opportunities but, more importantly, for identifying truly outstanding entrepreneurial talent to make it happen. Wetzel (1987) was among the first to recognise the benefits of experience in stating: "...the intensity of an individual's interest in (private) venture investing appears to be dependent in part upon the investor's familiarity with the techniques of successful venture investing.... Learning the tricks of the trade takes time and time is scarce." (311). Investors who have completed numerous private investments have, in all likelihood, experienced both successes and failures (van Osnabrugge 1998a). Based on this experience, we would maintain that investors gain, with the passage of time, an appreciation of what contractual safeguards are critical to protect their interests up front. One would also expect that experienced investors have a broader base of knowledge of when and how to interact with the entrepreneur in a manner that has the most beneficial impact for the venture's development. Practically speaking, it is also reasonable to suggest that active investors also face "capacity constraints" - with larger portfolios of investments to manage at any one point in time, it is not possible to devote a great deal of time to interacting with any one venture to the exclusion of others in the portfolio.

The potential for opportunistic behaviour to occur is mitigated, we would argue, as individuals become more adept at managing relationships with entrepreneurs, particularly so for the vast majority of private investors who were, at one time, entrepreneurs themselves. Investors who have "been on both sides of the table" can well appreciate the challenges associated with building a new venture and may empathise with the entrepreneur (Sullivan 1991). Previous research has concluded that a transition in "investor mindset" is required from being able to "manage a venture" to "managing an investment". Anecdotal evidence would suggest that this transition is often difficult to make and that the skills required to be an effective entrepreneur as compared to an effective investor are not the same (Kelly and Hay 1996b). To effectively manage a large portfolio of investments implies that investors are able to focus their governance effort by documenting deals efficiently and quickly and by selectively interacting with the venture at times when it is most beneficial to do so. This line of reasoning would suggest that those individuals who have completed numerous investments will adopt a much more parsimonious approach with respect to how their relationship with the entrepreneur is structured ex ante and monitored ex post[5]. It follows that:

H4a: The greater the number of investments made by an investor, the less comprehensive the contractual safeguards built in ex ante.

H4b: The greater the number of investments made by an investor, the less intensive the anticipated level of contact maintained with the venture ex post.

__Active Involvement As A Risk Management Tool__

Received research supports the view that private investors are attracted to opportunities where they have skills and experience that are potentially beneficial to the development of the venture (Mason, Harrison and Allen 1995). While being a key non-financial motivation for investors (Wetzel 1981), active involvement can also afford the opportunity for investors to influence and direct the entrepreneur's behaviour in a manner that promotes the economic interests of all parties (Sapienza 1992) and thereby a means for managing risk (Fiet 1995b). What implications might this have for investors in determining how to structure their relationship with the entrepreneur? Active involvement implies that investors not only want to

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[5]van Osnabrugge (1998a) argued that more active investors, so called serial investors, pay relatively more attention to contractual detail in the face of realised losses and less time devoted to hands on monitoring. A similar line of argument was advanced by Landström, Manigart, Mason and Sapienza (1998).

be intensively involved in the development of the venture post investment, but that a certain degree of contractual clarity is sought up front to define the roles and expectations of both parties to the transaction. Proceeding on the assumption that an investor's predisposition towards a specific risk management tool, active involvement, is a direct function of their desire to actually rely on it, it follows that:

H5a: The more effective active involvement in the venture development process is viewed by investors as a means for managing risk, the more comprehensive the contractual safeguards built in ex ante.

H5b: The more effective active involvement in the venture development process is viewed by investors as a means for managing risk, the greater the anticipated level of investor contact with the venture ex post.

4.5 Deal Attribute Variables

i) Investment Style

Private investors can choose to invest on their own or in syndication with other private individuals and/or venture capital funds. Preliminary evidence gathered in the UK supports the view that a majority of private investors operate as "lone wolfs", choosing to invest on their own (Harrison and Mason 1992)[6]. Particularly active market participants, referred to as serial investors, exhibit a very strong tendency to invest alongside other private individuals in the UK (Kelly and Hay 1996b); an observation which lends support to the emerging view that significant sub-segments may exist within the overall population of private investors (Gaston 1989b; Stevenson and Coveney 1994; Wetzel 1994). Syndication appears to offer four key advantages for investors who can: i) broaden their network of contacts to generate additional

[6]Although it should be noted that the respondents to the survey were registered with a specific business introduction service in the UK, the Local Investment Networking Company (LINC), which may represent a potential source of bias insofar as individuals that choose to use such a service may systematically differ from the broader population. This observation is decidedly tentative as the market is invisible and thus it is not possible to assess the representativeness of any sample when the characteristics of the population from which it is drawn is not known with certainty.

deal flow; ii) benefit from the perceived advantages of having "numerous eyes" assess the potential risks associated with a deal; iii) participate in larger investments; and in doing so, iv) diversify their risks.

Implications for Governance Effort

When an individual chooses to participate as part of a syndicate, the group as a whole can, in the course of due diligence, examine the merits and risks associated with the investment from their individually unique yet, in terms of the group as a whole, collectively eclectic perspective. It seems reasonable to suggest that the combined base of experience of a syndicate of investors is broader and deeper than is the case for most individual investors alone and, as a result, the degree of information asymmetry between themselves and the entrepreneur is lower in syndicated as opposed to solo investments. To the extent that this line of reasoning holds true, and consistent with the transaction cost and agency theory perspectives, the level of governance challenge faced by investors is lower when investing as part of a syndicate and this should be reflected in the form of less comprehensive contracts up front and less intensive monitoring of the venture ex post strictly speaking.

On a practical level, however, when numerous investors are involved in a particular deal, the likelihood for conflict to emerge between members of the investing syndicate and between individual investors and management may be quite high. Having said this, it may be advisable for investors and the entrepreneur to define the rights and obligations of both parties in much more detail than might otherwise be the case. Thus one can argue that syndicated deals might involve significantly greater care and attention to contractual detail.[7] Moreover, there are reasons to believe that the level of investor contact with the ventures can be

[7] Landström, Manigart, Mason and Sapienza (1998) also advance the view in their study that each investor brings their own opinion as to what clauses are important to include up front and how the relationship with the entrepreneur should be managed ex post. They conclude that syndicated deals imply much more comprehensive formal and informal agreements crafted ex ante.

greater in the case of syndicates. On the demand side, with a diverse base of experience upon which to draw, entrepreneurs may find it beneficial to draw in as much input from investors as possible. On the supply side, individuals within a syndicate can devote relatively less time individually but relatively more time collectively to the venture's development than might otherwise be the case if they were to invest on their own.

A priori, there is no reason to believe that one interpretation outweighs the other in terms of significance. We therefore do not expect to find any relationship between investment style and level of governance effort expended by investors. We would maintain that:

H6a: There is no relationship between the manner in which the investment was made (syndicated or solo) and the comprehensiveness of the contractual deal struck with the entrepreneur ex ante.

H6b: There is no relationship between the manner in which the investment was made (syndicated or solo) and the anticipated intensity of investor contact with the venture ex post.

ii) Investment Size

Both the transaction cost and agency perspectives maintain that controlling for potential opportunism is costly. Writing and enforcing the terms of a contract and monitoring agent behaviour implies investments by the investor both in terms of time and financial resources. Venture capitalists maintain that the financial and time commitment associated with properly structuring and monitoring an investment are largely fixed irrespective of investment size. As evidence, there has been a marked and continual shift by UK venture capital funds away from investing relatively small sums of capital (<£500,000) in view of the perceived economies of scale to be achieved by participating in larger deals[8] (Murray 1994). If transaction and agency costs are largely viewed as fixed, irrespective of investment size, investors would be

[8]Competition for larger, management-buy-out transactions has been intensifying, however, with the implication that the valuations at which deals are priced rises which, in turn, drives down potential returns for all market participants.

discouraged from incurring large transaction or agency costs in relatively smaller deals. In other words, if there is an implied cost associated with the level of governance effort expended, we would argue that more care, time and attention to contractual detail up front and relatively more intense investor interaction with the venture ex post can be expected when larger sums of capital are at risk. It follows that:

H7a: The larger the amount of the investment, the more comprehensive the contractual deal struck with the entrepreneur ex ante.

H7b: The larger the amount of the investment, the more intensive the anticipated level of investor contact with the venture ex post.

Having said this, private investors do display a propensity to invest in smaller amounts and at earlier stages of development than do venture capital funds (Wetzel 1994). What governance implications does this pattern of investment activity have for private investors? The milestone method of providing equity finance, while affording the option for investors to abandon less promising projects (Sahlman 1990), can place severe limits on a venture's ability to withstand competitive or other environmental shocks. This is particularly an acute problem for businesses in their formative stages of development that may not have a complete and balanced management team in place. In short, there is reason to believe that the level of business risk faced by investors declines as a function of venture age, an assertion consistent with Stinchcombe's (1965) "liabilities of newness" hypothesis. Compounding this, private investors inherently face agency risk from the outset as they are only truly able to assess the competence and integrity of the entrepreneur as information related to the performance implications of their behaviour is obtained. Placing relatively small amounts of capital at risk in such situations is a perfectly reasonable response by investors to limit the downside. However, these very deals also imply the assumption of higher levels of business and agency risk than might be faced by venture capital fund managers in particular. Controlling for these risks implies greater attention to detail on the part of investors in formulating contracts ex ante and more intense involvement with the venture ex post in view of the pressing development needs of the business. It follows that:

H8a: The smaller the amount of the investment, the more comprehensive the contractual deal struck with the entrepreneur ex ante.

H8b: The smaller the amount of the investment, the more intensive the anticipated level of investor contact with the venture ex post.

iii) Size of Respondent Equity Stake

A central tenet of agency theory is that agents who retain relatively low equity stakes with respect to principals may consume perquisites, the full cost of which is only partially borne by themselves (Jensen and Meckling 1976). As discussed in Chapter 3, much of the work upon which agency theory is based focuses on the incentive problems associated with managers in publicly traded firms who hold relatively small equity stakes in comparison to outside investors. Sapienza and Gupta (1994) observed that in situations where the equity ownership in a venture is concentrated among a small number of parties and in which the entrepreneur/management team retains a significant equity stake, a threshold effect may be operating insofar as beyond a certain point the interests of principal and agent converge[9]. Principals bear a disproportionately large part of the costs of managerial opportunistic behaviour when their stake in the outcome is relatively large as compared to management. Both the transaction cost and agency theory perspectives would advocate the use of contractual safeguards up front and ongoing monitoring by the principals ("investors") to mitigate this risk. It follows that:

H9a: The higher the equity stake of the investor in the venture, the more comprehensive the contractual deal struck with the entrepreneur ex ante.

H9b: The higher the equity stake of the investor in the venture, the more intensive the anticipated level of investor contact with the venture ex post.

[9]This view is consistent with Jensen and Meckling (1976) who would maintain that as the equity stake of the entrepreneur rises, agents bear a greater proportion of the costs associated with consuming perquisites.

iv) Nature of the Referral Source

Received research supports the view that private investors hear about potential investment opportunities from a variety of different outside sources, particularly from close personal friends and business associates, and as a result of their own search activities (Harrison and Mason 1996b). Freear, Sohl and Wetzel (1994a) have also demonstrated that some referral sources are of better perceived quality than others so in a real sense, the source of deal referral appears to matter. While private investors rely more on themselves than on other people to assess the agency risk associated with a given opportunity (Fiet 1995a), deal referrers can be a useful source of information about the proponents involved. To the extent that deal referrers are trusted by the investor *and* are personally knowledgeable about the entrepreneur involved, the information possessed by the referrer has potential value to the investor insofar as it may reduce the perceived level of agency risk associated with a given deal in their own mind. To the extent that the opinions of knowledgeable and trustworthy referrers matters to investors, we should expect to see the value of such information reflected in the form of the contractual deal struck up front and the perceived need for investors to closely interact with the venture post investment. It follows that:

H10a: If an opportunity has been referred on by a referral source that is both trusted by the investor and has personal knowledge of the proponents involved, the less comprehensive the contractual deal struck with the entrepreneur ex ante.

H10b: If an opportunity has been referred on by a referral source that is both trusted by the investor and has personal knowledge of the proponents involved, the less intensive the anticipated level of investor contact with the venture post investment.

v) Degree of Interpersonal Trust Between Investor and Entrepreneur

We argued that in both the transaction cost economics and agency theory perspectives, little scope was provided for trust to prevail in the relationship between investors ("principals") and entrepreneurs ("agents") (Ghoshal and Moran 1996).[10] In the informal venture capital market, received research would support the view, that from the outset, the relationship between private investor and entrepreneur is one that is infused with high levels of interpersonal trust. Throughout the due diligence phase, investors are not only evaluating the opportunity and assessing the capabilities of management, but in a very real sense they are forming an opinion as to whether the "personal chemistry" between themselves and the entrepreneur is "right". In the words of one accomplished private investor: "No matter how good the opportunity that is presented to me, if I can not get along with, and trust the people who are going to make it happen, I will not make the investment." By using the term "informal", it is strongly implied that investments are "done on a handshake" with minimal effort or attention devoted to explicitly spelling out terms, conditions and reporting requirements.[11] In the absence of efficiently operating external markets for entrepreneurial talent (Cable and Shane 1997), one could argue that it makes little sense for investors to "cross all the t's" and "dot all the i's" in any event. The key individual who must be satisfied with the terms of the deal is the "virtually irreplaceable" entrepreneur.

If investors do place a great deal of stock on the quality of the relationship with the entrepreneur, they may be reluctant to do anything which may sour the relationship from the very beginning and are sensitive to the notion that entrepreneurs in general display a strong internal locus of control. Imposing numerous terms, conditions and reporting requirements on individuals who have a strong desire to feel "in control" may be conveyed as a powerful "signal of distrust" by the entrepreneur (Landström, Manigart, Mason and Sapienza 1998).[12]

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[10] There is a growing body of literature recognising the importance of reputation effects that agents can develop over time by acting in a manner consistent with the principal's best interest (see for example Lambert 1983; Holmstrom 1979; and Levinthal 1988). The focus of this work has been on the interaction that occurs after the terms of the relationship are established.

[11] Landström, Manigart, Mason and Sapienza (1998) maintain that, relative to venture capital investments, informal venture capital deals should tend to be less elaborate in nature in terms of the contract negotiated.

[12] As the vast majority of private investors were once entrepreneurs themselves, one could argue that they are particularly sensitised to this issue. Some authors have gone so far as to state that private investors address an "empathy gap" as well as the "funding gap".

In this study, we will use a multi-dimensional construct of trust which captures the extent to which: i) the entrepreneur was open and honest in disclosing material facts during the due diligence phase, ii) the entrepreneur could be trusted to deliver on their promises, and iii) the entrepreneur would take decisions in the best interests of all shareholders. In short, we believe that trust may have an important influence on the need for investors to build in elaborate contractual safeguards up front and/or closely monitor the venture's development ex post. As argued in Chapter 3, both the transaction cost economics and agency theory perspectives are grounded in a "presumption of distrust"; it is simply not possible to accurately discern who can be trusted and who can not (adverse selection) and, as a result, opportunism is an ever present problem. Working from a "presumption of trust", we should observe a direct influence on the choices investors make with respect to structuring the deal ex ante and monitoring developments ex post as follows:

H11a: The level of trust that exists between the investor and entrepreneur will moderate the need for investor to build in contractual safeguards ex ante.

H11b: The level of trust that exists between the investor and entrepreneur will moderate the need for investors to closely interact with the venture ex post.

vi) The Presence of an "Investor-Employee"

Previous research in the informal venture capital area has confirmed that an important motive for investment for a sizeable proportion of private investors is the opportunity to "create a job for themselves". Creating employment and/or an income stream was a principal attraction for over one-third of the respondents in the largest ever study of the UK informal venture capital market (Stevenson and Coveney 1994). Employment within a venture affords an investor the opportunity to monitor the venture's development and influence decisions taken in a more intimate and far reaching way. In effect, agency risk can be "micro-managed" by investors at the source. It is reasonable to suggest that having an investor work with the venture in an employment capacity, should mitigate the need to build highly elaborate contractual safeguards at the outset. In addition having an "on-site monitor" should greatly reduce the need, particularly for outside investors, to closely monitor the venture's development. In short, it would be difficult for an entrepreneur to engage in sub-optimal behaviour and the risk of detection would increase in situations where an individual assumes the role of both "investor" and "employee". It follows that:

H12a: The presence of "investor-employees" will moderate the need for investors to build in comprehensive contractual safeguards ex ante.

H12b: The presence of "investor-employees" will moderate the need for investors to interact with the venture ex post.

4.6 Control Variables (DISTANCE and STAGE)

In an effort to aid subsequent analysis, two control variables were introduced into the model: i) travel time to the venture from the investor's home base (DISTANCE); and ii) the venture's stage of development (STAGE). Each of these control variables will be discussed in turn.

DISTANCE

Previous research has demonstrated that private investors display a propensity to invest in ventures located in close proximity to their home base of operation and that they are generally active participants in the venture development process (Wetzel 1981; Aram 1989; Tymes and Krasner 1983; Mason, Harrison and Chaloner 1991; Postma and Sullivan 1990; Freear, Sohl and Wetzel 1994a; Riding and Short 1987b). Active and effective involvement implies not only that the investor has the capability to contribute but the capacity to do so. Distance can thus create a substantial barrier to face-to-face interaction between investor and entrepreneur.

Where a venture is located in close proximity to an investor, it seems reasonable to suggest that investors can spend relatively more "hands on" time working with entrepreneurs. Both the transaction cost and agency theory perspectives advocate that monitoring is one method of curbing the potential for opportunistic behaviour to occur on the part of entrepreneurs. In situations where distance between the parties makes face-to-face interaction difficult, both perspectives would encourage investors to incorporate additional contractual safeguards up front to compensate for their inability to monitor the entrepreneur's behaviour as closely as they should. Geographic proximity does appear to have some bearing and influence on the choices investors make with respect to dealing with governance challenges, particularly as relates to the ability of investors to engage in hands on monitoring activity. While having few theoretical implications in itself, the variable DISTANCE is introduced as a control variable so that the impact of other predictor and moderating variables correlated with it are not misinterpreted.

STAGE

To aid subsequent analysis, a second control variable, venture stage of development (STAGE), is also introduced into our model. Many previous studies in the field of entrepreneurial finance have incorporated STAGE as an important predictor variable (see for example, Sapienza 1989). Ventures in the earliest stages of development often face numerous technological and market uncertainties compounded by "liabilities of newness" (Stinchcombe 1965), namely that the necessary managerial and financial resources to support growth are not readily forthcoming. In some ways, stage of development is a conceptually convenient proxy for "uncertainty" and, thus, should have some bearing on the choices investors face with respect to how to structure their relationship with the entrepreneur. To the extent that the need for close investor involvement in the venture's development reduces over time, we might reasonably expect to see lower levels of monitoring in later stage ventures. Conversely, with presumably a longer and more established track record of performance, and needs for larger infusions of capital, later stage ventures may entail relatively more attention to contractual detail than might otherwise be the case. We would expect to see STAGE correlated with a number of our predictor variables, notably those related to investment size (bigger deals are typically done in later stage ventures), investment style (larger investments are likely to be done in syndicates), and the level of equity stake retained by the entrepreneur (large stakes are surrendered when large amounts of capital are raised in later stages of development). As with the other control variable (DISTANCE), venture stage of development may very well influence the choices investors make as to how to structure and manage their relationship with the entrepreneur (Landström, Manigart, Mason and Sapienza 1998). However, in order to reduce the chance of confounding effects on subsequent analysis, we considered it important to incorporate STAGE as a control variable.

4.7 Conclusion

In this chapter, we developed a model that outlined the linkages that exist between specific contextual variables and the level of governance effort observed in the relationships between private investors and entrepreneurs. In doing so, we identified situations where the propensity of opportunistic behaviour to occur on the part of the entrepreneur was high. Faced with governance challenges, the transaction cost economics and agency theory perspectives would advocate that investors can protect themselves against the impact of opportunism by: i) building in contractual safeguards as part of the deal struck with the entrepreneur ex ante; and/or ii) monitoring the venture's development and entrepreneur's behaviour closely. In our model specification, "governance effort" is measured in two distinct, but interrelated[13] ways capturing both the essence of the contractual deal struck with an entrepreneur *and* the anticipated level of investor interaction with the venture, other than in

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[13] The measures are interrelated inasmuch as specific contractual provisions may give rise to the need to interact with the venture on a regular basis (for example, by specifying

an employment capacity.

In an effort to aid subsequent analysis, two control variables were introduced, DISTANCE and STAGE. While these two variables may exert an influence on the choices investors make with respect to how best to deal with governance challenges, we chose to control them so that the impact of other predictor variables correlated with these two variables was not misinterpreted. Relying on the transaction cost economics and agency theory perspectives, a number of hypotheses were advanced which are summarised in Table 4.4 below.

In the chapter that follows, we will discuss in detail the research methodology employed, the steps taken with respect to developing the survey instrument, and the means by which a sample of potential respondents was identified. The operationalisation of key constructs that form the basis of the model described in this chapter together with a detailed discussion of the statistical procedures to be used to empirically test the model will also be presented. It is to this discussion that we now turn.

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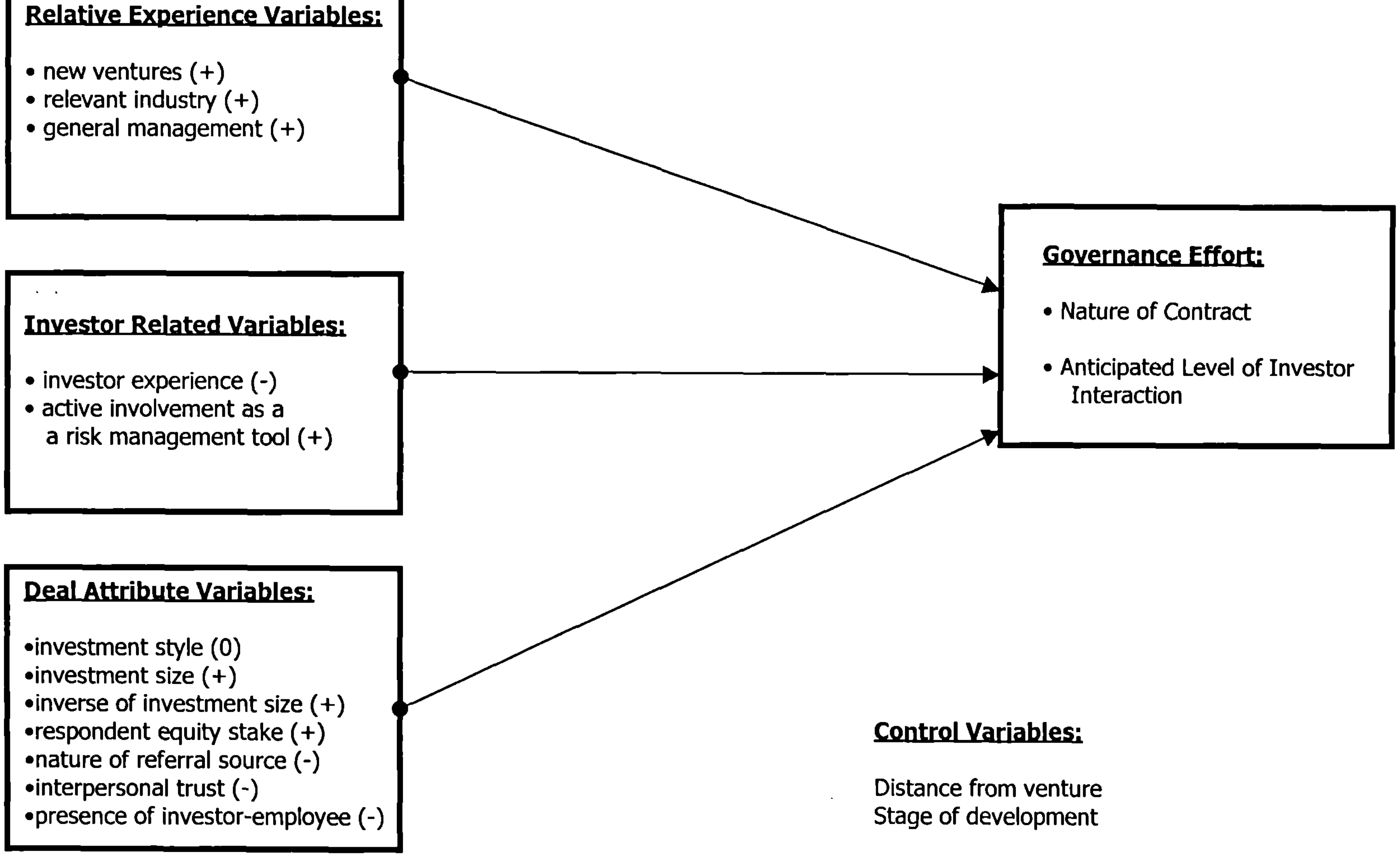
the number of times the board of directors shall meet). In addition, specific monitoring rights can be included as part of the contractual agreement.

Table 4.4 MODEL SUMMARY

Variables	Comprehensive Contractual Safeguards (CONTRACT)	Anticipated Level of Investor Interaction (CONTACT)
	Prediction (Hypothesis)	Prediction(Hypothesis)
Relative Experience Variables:		
New Venture Experience (EINVEEXP)	+ (H1a)	+ (H1b)
Relevant Industry Experience (EIINDEXP)	+ (H2a)	+ (H2b)
General Management Experience (EIGMEXP)	+ (H3a)	+ (H3b)
Investor Related Variables:		
Experience as an Investor (INVEXP)	- (H4a)	- (H4b)
Involvement as Risk Management Tool (ACTIVISM)	+ (H5a)	+ (H5b)
Deal Attribute Variables:		
Investment Style (STYLE)	0 (H6a)	0 (H6b)
Investment Size (EXTINV)	+ (H7a)	+ (H7b)
Inverse of Investment Size (INVEXTINV)	+ (H8a)	+ (H8b)
Respondent Equity Stake (EQUITY)	+ (H9a)	+ (H9b)
Nature of Referral Source (REFERRAL)	- (H10a)	- (H10b)
Interpersonal Trust (TRUST)	- (H11a)	- (H11b)
Presence of Investor-Employee (FULLTIME)	- (H12a)	- (H12b)
Control Variables:		
Travel Time from Venture (DISTANCE)		
Venture Stage of Development (STAGE)		

Exhibit 4.1: Contextual Influences and Governance Effort



CHAPTER 5: RESEARCH METHODOLOGY

In the previous chapter, we developed a predictive model to explain the influence that contextual factors have on the governance effort exhibited by investors towards a specific investment relying on the transaction cost and/or agency theory perspectives as appropriate. In this chapter, we will outline the methodology used in this study. The discussion is organised as follows: i) the rationale for selecting a postal survey design; ii) the phases of development of the survey instrument itself; iii) the decisions taken to identify a sample of respondents from a largely invisible population; iv) the specification of individual constructs; v) the statistical methodology used to test the hypotheses developed in Chapter 4; and vi) a discussion of the merits and limitations of the methodology employed.

5.0 Rationale for Selecting a Survey Research Design

As discussed more fully in section 2.2, perhaps the greatest challenge faced by researchers in the domain of informal venture capital is that the market by its very nature is largely invisible. Access to this market is jealously guarded by both the private investors themselves and by various intermediaries that channel deal flow between those seeking capital and those who can provide it (Benjamin and Margulis 1996). Overcoming barriers to access implies significant investment both in terms of time and resources on the part of researchers in order to identify potential respondents and/or garner the trust of intermediaries to facilitate the identification process on their behalf. Even if these barriers can be overcome, the ability of researchers to make generalisations is inherently restricted by virtue of the fact that it simply is not and will never be possible to describe the attributes of the population under study regardless of the nature of the research design employed. Nor is it strictly possible to build upon the fieldwork of others as the "cardinal rule" in undertaking research in this domain is to never disclose the identity of respondents.

To date, a variety of approaches have been used to collect data on the informal venture capital phenomenon including postal surveys, interviews, simulation and verbal protocol analysis. For the most part, researchers have tended to rely on survey instruments administered with the co-operation of intermediaries, such as business introduction agencies, in an effort to reach as many potential respondents in the least invasive manner as possible while respecting their privacy. In addition to the ability to "reach" more respondents, surveys facilitated the process of collecting basic data about a largely unexplored phenomenon both within and between countries. The administration of surveys have also afforded the opportunity for researchers to develop their own proprietary database of contacts, a resource that greatly facilitates and supports the capacity to undertake more researcher intensive designs such as interviews and verbal protocol analysis that afford the opportunity to probe in more depth and with a greater degree of researcher control than can generally be achieved with surveys. Faced with the dual handicaps of insufficient financial resources and a limited proprietary database of private investor contacts upon which to rely, the decision was made to employ a survey research design.

5.1 Survey Instrument Design

The development of the survey instrument and subsequent data collection activities involved three distinct phases: i) field interviews; ii) the pilot study; and iii) the survey administration itself. Each of the phases proceeded in sequence with the objectives of: i) gaining "hands on" experience and understanding of the informal venture capital phenomenon from the perspective of active market participants; ii) incorporating the knowledge so gained into the survey instrument itself; and, very importantly, iii) building the necessary degree of personal trust between potential respondents, facilitating organisations and the researcher to elicit a reasonable number of responses during the survey administration phase.

In this study, face-to-face interviews with individual investors were used to collect qualitative data that formed the basis of the survey design. The pilot study and survey administration was in the form of a postal survey. In addition, the final phase incorporated contacts established as a result of formal presentations made by the researcher to three investor groups.

Phase 1: Field Interviews

In addition to completing a review of background literature in the informal venture capital area, the researcher considered it important to gain a more fundamental understanding of the phenomenon at first hand. The objectives during the field interview phase were to: i) identify issues of interest to investors and entrepreneurs seeking capital alike; ii) gain a measure of "face credibility" with market participants and facilitating organisations such as Venture Capital Report (VCR) and business introduction agencies such as the South West Investment Group (SWIG); and iii) encourage the active involvement of outside practitioners in the development of the survey as a further means of generating interest.

Over a period of twelve months, the researcher attended: i) one private investor workshop organised by Venture Capital Report, publisher of a monthly investment opportunity bulletin distributed to 700 UK-based subscribers; ii) ten meetings of private investor clubs which serve as a forum for discussing issues of mutual interest and a means by which investors can broaden their network of contacts; and iii) twenty investment opportunity meetings in which entrepreneurs seeking funds make formal presentations to a group of private investors in a neutral venue. Face-to-face interviews (one to four hours duration) were arranged with ten active investors to gain more in-depth personal knowledge of the mechanics of completing private equity transactions. In addition, in-depth discussions with private investor network managers, lawyers, accountants and consultants who specialise in the informal venture capital area were also arranged to gain additional insights.

In aggregate, these investors had started sixteen ventures of their own and had invested in excess of £15 million (ranging from £50k to in excess of £10 million) in seventy-five entrepreneurial ventures. Drawing upon the collective experience of this group of active market participants proved invaluable in gaining a deeper understanding of the mechanics of investing in privately-held firms and helped the researcher to identify possible "knowledge gaps" in the market. The interviews were semi-structured in nature with participants providing detailed information on their personal backgrounds, their experience as investors and entrepreneurs, the criteria they used to screen and evaluate potential investment opportunities, and deal specific information on every private investment they had completed to date. To guide the search for a research topic that was both feasible in scope and of practical relevance and interest to potential respondents, each interview finished with the open-ended question: "What are the key unresolved issues in your mind which hamper the development of the informal market for venture capital?" All of the interviewees agreed to participate in the subsequent pilot study phase.

Phase 2: The Pilot Study

One of the consistent themes which was raised during the field interview phase by investors and network administrators alike was the perceived "misperception" on the part of entrepreneurs of the onerous nature of the terms and conditions upon which informal venture capital could be obtained. An area of consensus was that entrepreneurs were generally reluctant to explore the option of raising external capital because of fears associated with the implied "loss of control" such a decision entails. It was also clear that many promising investment opportunities were not completed as a result of disagreements between the investor(s) and entrepreneur on the "terms of the deal". Admittedly, these perceptions incorporate the views of only one side of the entrepreneur-investor dyad. From the standpoint of the entrepreneur seeking capital, a large scale study in the UK affirms the notion that two major barriers to firm growth as reported by entrepreneurs are: i) the unavailability of capital on "reasonable terms"; and ii) the perceived loss of control associated with raising external equity (Hay and Khamshad 1994). Educating entrepreneurs as to the benefits to be gained from raising informal venture capital and the terms and conditions upon which such equity can be raised was identified as a major challenge by all network administrators contacted and is highlighted in a report that has recently been submitted to the European Commission (EBAN 1998).

The approach used to develop the survey is consistent with the Total Design Method (TDM) as recommended by Dillman (1978). Based on social exchange theory (Homans 1961; Blau 1964), TDM maintains that respondents will only participate in a research project if, in their mind, the expected benefits of participating outweigh the perceived costs of so doing. TDM is based on three objectives: i) maximising the rewards for participants, ii) minimising the cost of responding, and iii) creating a measure of trust between researcher and respondent.

By using a broadly inclusive and consultative approach during the field interview phase and throughout the development of the survey design, the researcher sought to offer respondents a number of rewards of an intangible nature as identified by Dillman (1978) including: i) demonstrating positive regard towards them; ii) expressing verbal appreciation when possible; iii) utilising a consultative approach; and iv) constructing the survey in such a manner as to make it intrinsically interesting and visually appealing. A cover letter formed part of the survey instrument itself thanking respondents in advance for their co-operation and inviting them to participate in networking events sponsored by the Foundation for Entrepreneurial Management (a copy of the survey instrument is attached as Exhibit 5.1). In addition, three business introduction organisations and Venture Capital Report independently endorsed the importance of the project vis-à-vis their respective constituencies by agreeing to participate in the final survey administration.

According to Dillman, the "perceived cost" of participating in a given research project can be reduced through: i) designing the instrument to make it appear brief; ii) minimising the physical and mental effort required of respondents; iii) guarding against embarrassing the respondent or making them feel subordinate to the researcher; and iv) minimising out-of-pocket expenses wherever possible. The final survey instrument filled two sides of A4 and could be completed in twenty minutes. Parties consulted during the development of the instrument also commented that the format was clear and visually appealing. A postage-paid self-addressed envelope was also enclosed for the respondent's use.

Dillman also suggests that is important for researchers to establish a relationship of trust with respondents by: i) showing appreciation in advance; ii) co-opting the legitimacy of recognised organisations or institutions, and iii) leveraging advantages from related exchange relationships. In this regard, the interview phase was critical in developing a measure of trust with facilitating organisations and individual investors alike. In view of the wide variety of organisations and events through which initial investor contacts were made, it was possible to identify a reasonably large (n=52) group of active investors to participate in the pilot study. A personal letter was sent to each potential respondent inviting them to participate in the research project and encouraging them to make any comments and/or suggestions about the survey instrument itself.

In total, the pilot study yielded a 60% response rate (n=31) which is comparatively large when compared to the single digit response rates achieved in the path-breaking research conducted in the UK (Harrison and Mason 1992) and is testament to the value of using the TDM approach. All of the surveys were completed in their entirety and no respondents reported difficulties interpreting any of the questions or identified any glaring omissions. In total, these investors had made 292 investments (range 1 to 50) or 9.4 on average. Nearly three-quarters of the respondents had started a business of their own and of those that had, the average number of businesses started on their own was almost three. Each respondent provided detailed information on the most recent investment they had made in an entrepreneurial venture for the first time. Three of every four investments was done in syndicate with other private investors and/or venture capitalists. The average investment made by the individual investor was £85,000 with syndicate partners investing a further £280,000. In almost a quarter of the investments, the entrepreneur had made no capital contribution to the venture ("sweat equity"), but for those that had, the average amount of personal capital invested was £60,000. In almost two-thirds of the investments, the entrepreneur retained an equity stake of 50% or more.

Aside from providing us with an opportunity to "test out" the survey instrument, we used the pilot phase to confirm the robustness of our multi-dimensional measure of interpersonal trust. On a five point Likert scale, ranging from "strongly disagree" (coded 1) to "strongly agree" (coded 5) and anchored by "neither agree or disagree" (coded 3), respondents were asked to indicate their level of agreement with three statements pertaining to the extent to which the entrepreneur: i) was open and honest in disclosing information to investors during due diligence; ii) could be trusted to deliver on their promises; and iii) would take decisions in the best interests of all shareholders. The descriptive statistics for each component of the multi-dimensional construct TRUST is summarised in Table 5.1 below:

Table 5.1: Multidimensional Trust Construct (Descriptive Statistics)

Interpersonal Trust Constructs: (Cronbach's alpha = .8358)	**Mean**	**Standard Deviation**
The entrepreneur / team was open and honest in disclosing all relevant information to investors	4.00	1.2111
I trusted this entrepreneur / team to deliver on their promises	4.03	0.9826
I trusted this entrepreneur / team would take decisions in the best interests of all shareholders	3.74	1.0636

In terms of internal consistency, the computed Cronbach's alpha of .8358 exceeds the minimum acceptable level of .80 for internal reliability for a multi-indicator scale (Bryman 1989). The observed means are on the positive side of neutrality which is consistent with the view that the economic relationship between investor and entrepreneur is generally infused with high levels of trust from the outset (Coveney and Moore 1998).

In summary, the survey instrument captured the data we wanted to obtain from investors in a clearly understood and time efficient manner. The multi-dimensional construct of interpersonal trust proved to be reliable and the survey instrument itself robust. Ideally, it would have been helpful to revisit the structure of the survey instrument itself at this point with a number of the respondents and non-respondents alike. Mindful however of our concerns about making the administration of the survey as least invasive as possible for respondents, we decided to proceed on a "no revisions" basis and therefore incorporated the responses obtained during the pilot study phase were included as part of the final data set. In short, we did not want to run the risk of alienating existing respondents by having them complete a "revised" survey or, for that matter, having them complain to other investors and, more particularly, to intermediaries. In view of the growing number of research projects that these individuals were being asked to participate in, the risk of alienation was judged by the researcher to be especially high.

Phase 3: Survey Administration

Once the results of the pilot study were analysed, the researcher made direct approaches to a number of prominent organisations to gain their endorsement to participate in the research project including:

- Venture Capital Report (VCR), an Oxford-based publisher of a monthly investment opportunity bulletin distributed to 700 subscribers nation-wide;

- The Great Eastern Investment Forum (GEIF) based in Cambridge which organises regular breakfast meetings for investors and entrepreneurs in Cambridgeshire;
- South West Investment Group (SWIG) which manages a small investment group in Cornwall and Devon; and
- The Yorkshire Association of Business Angels (YABA) which informally manages a small syndicate of private investors in Bradford-Leeds.

The organisations targeted were carefully selected for a number of reasons. First, most of the investors that participated in the pilot phase were based in southeast England. We wanted to broaden the base of respondents beyond "city investors". Second, VCR has a particularly strong presence in Oxford as does GEIF in Cambridge. There is a strong orientation towards technology and intellectual property intensive deal flow through these two organisations which has created something of an "informal venture capital phenomenon" in both of these areas; we wanted to be able to tap into this fertile area of innovative activity. Third, SWIG and YABA were included not only to try and achieve some measure of geographical diversification, but anecdotal evidence would suggest that the typical deal in their respective areas of domain are relatively small as compared to London and environs.

A variety of distribution methods were used, often involving significant lead times of up to three months' duration. Surveys were distributed: i) as part of a monthly investment bulletin (VCR), ii) along with a quarterly investor newsletter (GEIF), iii) in a highly targeted mailing (SWIG), or iv) in conjunction with a presentation made by the researcher before an investors meeting (YABA). In every instance, the survey was accompanied with a self-addressed postage-paid envelope. Confidentiality was assured, however, respondents could identify themselves if they wished to receive a copy of the summary report. In excess of 90% of the respondents to the pilot study did identify themselves which does lend some measure of credence to the belief that the study addresses issues of practical relevance and interest to investors.

5.2 Sampling Issues

One of the inherent challenges in undertaking research in the informal venture capital area is that the size and characteristics of the population are "unknown and probably unknowable" (Wetzel 1983). The market is largely invisible in character and there are no central registries one can consult to identify active market participants. In short, it is simply not possible to make any assertions about the representativeness of any sample in the absence of complete information about the population from which the sample is drawn. Potential respondents can be identified in a variety of different ways. Table 5.2 summarises four methods that have been used in previous research in the informal venture capital area and assesses the potential utility of each.

Table 5.2: Identifying Potential Respondents: Sampling Methods

METHOD:	ASSESSMENT:
Purchased Mailed Lists Individuals who, for example, are • Luxury car owners • Professionals (lawyers, doctors, etc) • Business school alumni	While it is possible to identify a potentially large pool of high discretionary income individuals, the cost associated with this approach is high and response rates achieved relatively low, often under 5%.
Firm Nomination Firms are approached directly and asked to identify private investors who have provided the firm with equity capital.	Fewer than 5% of firms have raised informal venture capital thus the direct cost of identifying individual investors is relatively high and effective response rates generally quite low.
Investor Nomination Once an initial base of investor contacts is made, individuals so identified "nominate" other contacts known to them. This approach is also referred to as "snowball sampling".	A cost effective means of leveraging an investor's network of contacts, however, biases can be introduced as the individuals nominated may be of similar mindset as the nominator. The costs associated with identifying and gaining the trust of an initial contact base are large, however.
Business Angel Networks Individuals who register as investors with an organisation that facilitates the equity search process for entrepreneurs.	A highly efficient source of contacts, however: i) investors often register with more than one service simultaneously thus creating a high degree of potential overlap; and ii) there are typically a high proportion of individuals registered who have yet to make their first investment.

In the pilot study phase, an investor nomination approach was used with great effect. The final survey administration was facilitated with the help of the following business angel networks: VCR, GEIF, SWIG and YABA. According to the 1996/1997 British Venture Capital Association Guide to Sources of Business Angel Finance, these four organisations reported a total of 1,055 investors in their respective databases.

Response rates to subsequent mailings was expected to be relatively low as compared to those achieved during the pilot study phase for a number of reasons: i) some of the investors who participated in the pilot phase are subscribers/members to one or more of the services which were approached; ii) there was a high degree of perceived membership overlap between the organisations - in effect, investors "troll" for potential investment opportunities from a variety of different sources simultaneously[1]; iii) a sizeable proportion of subscribers/members are professional intermediaries or service providers such as accounting firms and banks[2]; iv) anecdotal evidence would suggest that some investors "de-list" once they have identified and completed an investment presented to them by the respective service provider; and v) there is a significant proportion (often 20% or more) of the membership base which could be classified as "virgin investors" who have not, as yet, completed their first investment. As the targeted audience for this survey was investors who have made at least one investment, the potential size of the sample frame is substantially below the reported figure of 1,055, although it is not possible to determine with accuracy the exact number.

Incorporating the completed surveys from the pilot study phase (n = 31), a total of 123 responses was received. While the survey instrument was specifically targeted at private individuals who **had completed** at least one investment, six surveys were submitted by virgin angels who provided background information only. In addition, three professional intermediaries who invest on behalf of other individual clients also completed surveys. These nine responses were excluded from further analysis and thus the total sample comprised 114 respondents. As the bulk of the survey collected deal specific information on the *most recently completed* private investment made in a venture for the first time, there was a risk that data might be captured on a specific investment from more than one investor in a given

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[1] The potential for overlap to occur was considered to be very high in the case of VCR based in Oxford and GEIF based in Cambridge due to their close geographical proximity.

syndicate[3]. Individual investment data was scrutinised on the basis of: ii) original investment date; ii) size of investment made; iii) equity ownership distribution; iv) the size of the board of directors, and v) the relative composition of the board; to determine the extent of data overlap. On this basis, four additional responses were disqualified yielding a total sample of 110 responses as follows:

Completed Surveys Returned	123
less: Virgin Investors / Intermediaries	9
less: Redundant Responses	4
= Final Sample Size	110

Setting aside for the moment the concerns expressed about the potential subscriber/member overlap between the various business introduction services described above, we can calculate a rudimentary estimate of response rate of 10.4% based on a total sample frame of 1,055[4]. The first ever national study of informal venture capital in the UK (Mason and Harrison 1992) achieved low single digit response rates and fewer usable responses (n=86). A number of more recent studies in the UK (Coveney and Moore 1998; van Osnabrugge 1998a) have achieved higher absolute numbers of responses, however there appears to be a growing measure of "respondent fatigue" among UK private investors who have been asked to participate in numerous research projects in the past twenty-four months including an updated national survey conducted by Professors Colin Mason and Richard Harrison. The number of responses obtained could have been increased substantially had the personally engaging approach used in the pilot study phase been applied throughout the survey

[2] The estimated percentage of the membership base in Cambridge (GEIF) and the subscriber base of VCR that would fall into this category is estimated to be between 30% and 35%.

[3] Particularly so for investors registered with a business introduction service who, in addition to presenting investors with potential investment opportunities, help to facilitate the formation of investor syndicates.

[4] This assumes of course that all investors who participated in the pilot phase are also subscribers/members of one of the business introduction services that agreed to participate in this project.

administration phase. Unfortunately due to time and particularly financial constraints, it was not feasible to utilise this approach.

5.3 Description of Constructs

i) Predictor Variables

Relative Experience Variables

"**Knowledge of the transformation process**" was captured in two separate but identically structured sets of questions which asked investors to evaluate the amount of previous experience the entrepreneur/management team *and* the investors had in each of the following areas *at the time the investment was made*: i) in the new venture setting (**new venture experience**); ii) working in a relevant industry context (**relevant industry experience**); and iii) in general management positions (**general management experience**). Similar concepts have appeared in a large number of studies in the entrepreneurship field (Chambers, Hart and Dennison 1988; Chandler and Hanks 1991; Dunkelberg, Cooper, Woo and Dennis 1987; among others). Level of experience was measured identically using a five-point Likert scale ranging from "no previous experience" (coded 1) to "extensive experience" (coded 5) and anchored in the middle by "some experience" (coded 3).

Most previous studies relied on objective measures to capture level of experience, such as "years of experience". While desirable in terms of facilitating subsequent data analysis, objective measures pose practical problems for respondents in terms of their ability to accurately attribute what portion of their, and for that matter, the entrepreneur's working lives have been devoted to each of these areas. When coupled with the expectation that many private investments involved a syndicate of investors, the task faced by respondents was considered to be an exceedingly difficult one if objective measures such as "years of experience" was employed. We had reason to believe that relying on such measures would: i) increase the probability of non-response; and ii) introduce potential sources of reporting bias into the research design.

Investors who participated in the pilot phase uniformly agreed that the depth of experience measure developed facilitated response. For benefits of consistency, an identical measure was incorporated to capture the experience base of the management team. **Relative experience** was measured on the basis of dividing the experience rating of the entrepreneur/team on a specific dimension by the reported rating on the same dimension for the investor(s). Relying on qualitative measures of experience does introduce two potential biases into the design: i) investors holding differing perceptions as to matters of degree (for example, what constitutes "extensive" and "some" experience in their minds); and ii) overstatement on the part of respondents as to their own level of experience (self-reporting bias). One crude indicator of whether or not investors hold differing "perceptions of degree" is to examine the correlation between number of new ventures started (NVE#) and the level of experience in the new venture setting. As we were assessing the level of experience of the investor base as a whole, the correlation for the sample as a whole would be inappropriate as it incorporates confounding elements of other investor's experience in situations where a syndicate is involved. By filtering out all responses that involved syndicates, we can isolate responses that reflect an individual investor's experience only. The observed correlation between number of ventures started (NVE#) and level of experience in the new venture setting for solo investors is positive and highly significant ($r = .417$, $p = .016$). To gauge whether self-reporting is a potential source of bias, we compared reported investor experience base for deals which involved one investor versus those that involved a syndicate of investors. Assuming that the accumulated base of experience for a syndicate of individuals is, in all likelihood, greater than is the case for an individual investor alone, we should see demonstrably lower experience ratings for solo investors. Examining the average experience ratings on four dimensions (general management, relevant industry, new venture and sales/marketing experience), the observed mean for syndicates is 3.96 on a scale ranging from 1.00 (no previous experience) to 5.00 (extensive previous experience) as compared to 3.64 for solo investors.

Investor Related Variables

Numerous studies have captured data on the level of investment activity of private investors in the US (Freear & Wetzel 1989; Postma & Sullivan 1990) and in the UK (Mason & Harrison 1992; Coveney & Moore 1998). Unlike most of these studies which ask respondents how many investments were made in a defined period of time, we evaluated **experience as an investor** on the basis of the total number of investments an individual has made in privately-held companies. Stuart and Abetti (1988) assessed entrepreneurial experience by employing a measure that captured the number of previous new ventures started by an individual. Our measure of investor experience is a mirror image of this construct using number of investments as a proxy for investment as opposed to new venture experience.

To gauge investor's opinions as to the merit of being closely involved in the venture's development, we asked them to indicate on a five-point scale (ranging from 1 = "strongly disagree" to 5 = "strongly agree" and anchored by 3 = "neither agree or disagree") their level of agreement to the statement: "Frequent and informal interaction with the management is a very effective way to manage risk."

Deal Attribute Variables

Information on specific investment attributes was captured in an objective fashion through a number of directed questions. **Investment style** was classified on the basis of how the equity was invested and measured on an ordinal scale. Investors were provided with a mutually exclusive, yet exhaustive list of alternatives as follows: i) on my own (solo) (coded 1); ii) as part of a group of private investors (coded 2); iii) alongside a venture capitalist (coded 3); and iv) as part of a group of private investors and venture capitalists (coded 4). A dummy variable was created (STYLE) which partitioned the sample into two mutually exclusive groups: ii) solo investors (coded 0) and ii) syndicated investors (coded 1).

Respondents were asked to estimate the **size of their initial investment** in sterling detailing the amount of capital provided by: i) themselves personally; ii) other outside investors; and iii) the management team. Similarly, **size of equity stake** was estimated in percentage terms representing: i) their personal stake in the business; ii) other outside investor's equity interest; and iii) the residual attributable to management and/or employees.

To assess the **nature of referral source used**, investors were asked to indicate their level of agreement to the following statement: "This opportunity was referred to me by *a trustworthy* source who *knew* of the individuals involved." Responses were analysed on a five-point scale ranging from 1 = "strongly disagree" to 5 = "strongly agree" and anchored by 3 = "neither agree or disagree".

We maintained that the level of interpersonal **trust** that exists between investor(s) and entrepreneur was expected to reduce the need for investors to: i) build in comprehensive contractual safeguards up front; and ii) closely monitor the behaviour of the entrepreneur post-investment. By interpersonal trust, we adopt the definition proposed by Mayer, Davis and Schoorman (1995) of "...the willingness of one party (investors) to be vulnerable to the actions of another party (entrepreneurs) based on the expectation that the other (entrepreneurs) will perform a particular action important to the trustor (investor), irrespective of the ability to monitor or control (the behaviour) of that other party (entrepreneur)." (712) The authors make a useful distinction between trust ("a willingness to take risks") and risk ("making oneself vulnerable to the potentially damaging actions of another"). Tsai (1996) argues that trust is a multi-dimensional construct that involves both attitudinal and situational factors. Deutsch (1958) was among the first scholars to propose that personality traits explain why some individuals are more likely to trust others ("attitudinal trust") or what Mayer, Davis and Schoorman (1995) refer to as a "general propensity to trust". Kee and Knox (1970) were among the first to highlight that trust develops within a specific context ("situational trust").

In the only other study in the informal venture capital field that explicitly dealt with the role of trust in the private investor's decision-making process, Harrison, Dibben and Mason (1997) identified four types of trust. The concept of *swift trust* has been advanced to describe the emergence of relationships in which individuals have limited past experience working with each other, limited prospects for doing so in the future and who are brought together on a transitory basis under time pressure to undertake a non-routine task. *Calculus-based trust* involves the assessment by individuals contemplating entering a relationship with another of the potential benefits and costs of doing so. In situations where the individuals involved know of and have had interaction with each other, *knowledge-based trust* is said to exist. Finally, *identification-based trust* arises in situations where parties to the exchange have full understanding and appreciation of the other's wants/needs and share common values. The focus of their study was on the initial screening stage where investors decide whether to spend additional time and effort investigating a given opportunity further. A key insight of their work is on identifying and specifying the bases upon which trust irrespective of type is formed.

In their study, five bases of trust are identified as follows: integrity, competence, benevolence, perceived risk (potential loss) and expected outcome (potential upside). In the very early deal screening stage, they observe that private investors make swift judgements about the competence of the entrepreneur/team in particular and, to a much lesser extent, on the potential perceived losses inherent in the opportunity based on their experience. In our study, we are looking at completed deals, opportunities that presumably offer the investor an acceptable level of both perceived risk and, more importantly, upside potential. Having said this, we looked to the literature to develop relevant dimensions of the trust concept that tap into the notions of integrity (Butler 1991; Liebermann 1981; McAllister 1995; Sitkin and Roth 1993; Mayer, Davis and Schoorman 1995) and competence (Butler 1991; Mishra 1996; McAllister 1995; Mayer, Davis and Schoorman 1995). A number of studies have also developed constructs of trust that involve concepts such as openness (Butler 1991; Mishra 1996; Hart, Capps, Cangemi and Caillouet 1986) and reliability (Butler 1991; Mishra 1996, among others). As part of their model to explain the determinants of trust, Mayer, Davis and Schoorman (1995) identify benevolence as a factor. Benevolence, or deeply held feelings of positive regard for another individual, closely mirrors the notion of identification-based trust cited by Harrison, Dibben and Mason (1997). Significant interaction between the parties is implied for benevolence or identification-based trust to develop. In an effort to address recall bias by having investors report on their most completed investment, one could reasonably maintain that there is a limited basis for benevolence to develop between the parties (they likely have not spent an extended period of time interacting with each other in the venture) and so we chose not to incorporate a direct measure of benevolence into our trust construct. By relying on informative and trustworthy referral sources, however, investors may be able to develop indirect cues as to the motives and intentions of the entrepreneur.

For purposes of this study, we developed a multi-dimensional construct of interpersonal trust based on three indicators to measure perceived "integrity", "competence", and "openness". On a five-point Likert scale, from "strongly disagree" (coded 1) to "strongly agree" (coded 5) and anchored by "neither agree nor disagree" (coded 3), investors were asked to indicate their level of agreement or disagreement with the following statements: i) "The entrepreneur/team was open and honest in disclosing all relevant information to investors"; ii) "I trusted this entrepreneur/team to deliver on their promises"; and iii) "I trusted this entrepreneur/team would take decisions in the best interests of all shareholders". Each of the questions captures a different dimension of situational trust that received research has indicated is relevant including i) openness; ii) integrity; and iii) implied competence. To our knowledge, other than the exploratory work of Harrison, Dibben and Mason (1997), no other informal venture capital study has incorporated measures of situational trust into the research design although it is generally recognised that investors place a great deal of weight on the "personal chemistry" factor (Coveney & Moore 1998).

The observed Cronbach alpha of .8051 for our multi-dimensional construct of trust exceeds the minimum tolerance level for internal consistency of a multi-item scale (.80) as recommended by Bryman (1989). To assess construct validity, we examined the correlation coefficient between our trust construct and the responses provided by investors to the question: "Management committed a substantial portion of their net worth to the venture". In placing a substantial proportion of their own funds at risk entrepreneurs effectively send a signal to investors of their confidence in their own abilities and their willingness to incur bonding costs to secure external equity to support growth. A very strong ($r = .457$) and highly significant ($p < .001$) correlation coefficient is observed between our TRUST construct and commitment of capital on the part of the entrepreneur.

Unlike venture capitalists, a sizeable proportion of private investors do work closely with the venture in a full or part-time employment capacity (Coveney and Moore 1998). The presence of an "**investor-employee**" was captured as a dummy variable (FULLTIME) coded "0" if no investor or "1" if at least one investor was employed in the venture. Respondents were also asked to provide an estimate in hours per month of the time devoted by "investor-employees" *in an employment capacity.* In order to ensure that respondents clearly distinguished between level of contact in an *employment* versus an *investor* capacity, two separate questions were developed to segregate the predictor variable (*employment*) from the dependent variable (*contact*) explained in section iii) that follows.

ii) Control Variables (Distance and Stage of Development)

Similar to the approach used in a number of other informal venture capital studies (Postma and Sullivan 1990; Freear and Wetzel 1989; Mason, Harrison and Allen 1995), **distance from the venture** was measured on the basis of travel time from the investor's home base of operation. For purposes of analysis, travel time was converted into minutes.

Venture **stage of development** was evaluated on the basis of definitions adopted by the British Venture Capital Association (1995) consistent with the approach used by Coveney and Moore (1998). Respondents were asked to classify the stage of development of the venture at the time they first invested in one of the following categories: i) start-up (funds required for development and initial marketing - no commercial sales made as yet) (coded 1); ii) early stage (funds required to initiate manufacturing and sales - venture may not as yet be profitable) (coded 2); and iii) expansion (funds required to support growth of an existing firm - including turnarounds and bank refinancing) (coded 3).

iii) Dependent Variable: Governance Effort

Governance effort was captured in two questions that dealt with: i) the nature of the contractual deal struck with the entrepreneur (CONTRACT); and ii) the *anticipated* level of investor interaction with the venture *other than in an employment capacity* post investment (CONTACT).

Contractual Governance Effort (CONTRACT)

To measure the level of contractual governance effort (CONTRACT), a list of twelve *contractual provisions* was developed in consultation with investors, network administrators and a senior lawyer who is actively involved in private equity transactions as discussed in

Section 5.2 above. While the list presented to investors can not be considered exhaustive in nature, all of the individuals consulted agreed that it represented a very comprehensive list of *important and substantive* issues that are negotiated between investors and entrepreneurs and often feature in private equity shareholder agreements. A list of the provisions provided to investors is summarised below in Table 5.3:

Table 5.3: Contractual Safeguards: A Summary

1.	Investor veto rights over acquisitions and divestitures
2.	Investor approval required for strategic plans and/or budgets
3.	Management can be forced to seek an exit if required to do so by investors
4.	Investor approval required to hire and/or fire senior personnel
5.	The level of management compensation must be approved by investors
6.	Share options may not be issued without investor approval
7.	Non-compete contracts required of management upon termination
8.	Investor veto rights over capital expenditure plans
9.	Investor(s) countersign cheques above a certain amount
10.	Restrictions on the ability to raise additional debt or equity
11.	Management equity ratchet provisions are included as part of the deal
12.	A specific dispute resolution mechanism is agreed in writing

For all of the listed provisions, investors were asked to rate the importance of including each as part of the shareholder's agreement using a three-point Likert scale (1 = "not important"; 2 = "somewhat important"; and 3 = "very important"). Respondents were then asked to indicate which of the provisions was *actually included* as part of the deal struck with the entrepreneur, measured as a dummy variable coded 0 (not included) or 1 (included). A composite measure was developed (CONTRACT) for each respondent by counting the number of provisions which were included as part of the deal and applying arbitrary weights to each based on the importance attached to them by investors. Provisions considered "very important" by investors (coded 3) were assigned a full inclusion weighting factor of 1.00. "Somewhat important" ratings were assigned an inclusion weighting factor of 0.50. Similarly, where a provision was included and rated "not important" a minimal inclusion weighting factor of 0.25 was applied. The range of possible values for our composite measure

(CONTRACT) is thus established to be 0 (no provisions included) and 12 (all provisions included *and* all rated "very important"). To assess construct validity, we examined correlation coefficients between CONTRACT and the responses provided by investors using a five-point Likert scale to the statements: ii) "Terms and conditions of the deal with the entrepreneur/team should be as open and flexible as possible" (ICM1); and ii) "To ensure that management behaves in the best interests of shareholders, contractual safeguards should be included up front" (ICM4). A negative correlation (r=-.107) is observed between ICM1 and CONTRACT ($p < .15$) and a positive and statistically significant ($r=.161$, $p < .05$) correlation between ICM2 and CONTRACT as anticipated.

Interaction Governance Effort (CONTACT)

CONTACT with the venture was measured on an interval scale (hours per month) on the basis of estimates provided by investors as to the *anticipated* level of investor involvement with the venture in the form of: i) face-to-face meetings; ii) telephone conversations; and iii) in writing (reviewing reports and plans). Recent research in the informal venture capital area (Coveney & Moore 1998; Mason, Harrison & Allen 1995) have measured contact in terms of the number of times an investor visits or is in telephone contact with the venture. Measuring contact either on the basis of hours or frequency per month poses potential problems in terms of recall bias. We chose to measure on an interval scale which facilitated the consolidation of our multi-dimensional CONTACT construct into a single measure. To assess construct validity, we examined the correlation between CONTACT and investor responses on a five-point Likert scale to the statement: "Frequent and informal interaction with the management is a very effective way to manage risk" (ICM2). The observed correlation is positive and statistically significant ($r = .255$, $p < .01$).

Table 5.4 presents the descriptive statistics for the eleven variables described above which will form the basis for the statistical analysis of the model developed in Chapter 4. For purposes of exposition, descriptive statistics are also summarised for the individual measures that form the basis of some of the derived constructs presented in this chapter. In the section that follows, we will discuss the statistical procedures to be used to test the hypotheses advanced in the previous chapter.

Table 5.4 DESCRIPTIVE STATISTICS n = 106 (*excluding 4 outliers)	Mean	Standard Deviation	Min	Max
Relative Experience Variables:				
Relative new venture experience of entrepreneur to investor (EINVEEXP)	0.82	0.70	0.20	4.00
• entrepreneur's experience (ENVEXP)	2.58	1.32	1.00	5.00
• investor's experience (INVEXP)	3.85	1.26	1.00	5.00
Relative relevant industry experience of entrepreneur to investor (EIINDEXP)	1.78	1.24	0.20	5.00
• entrepreneur's experience (EINEXP)	4.23	1.04	1.00	5.00
• investor's experience (IINDEXP)	3.13	1.42	1.00	5.00
Relative general management experience of entrepreneur to investor (EIGMEXP)	0.87	0.64	0.20	5.00
• entrepreneur's experience (EGMEXP)	3.54	1.12	1.00	5.00
• investor's experience (IGMEXP)	4.50	0.83	1.00	5.00
Investors Related Variables:				
Investor experience (# INVESTMENTS)	7.75	8.23	1.00	50.00
INVOLVEMENT AS RISK MANAGEMENT TOOL	4.46	0.75	1.00	5.00
Deal Attribute Variables:				
Mode of investment (STYLE)	0.69	0.47	0.00	1.00
Total External Capital Invested (EXTINV) £000	322.52	480.13	1.00	2500.00
• provided by other investors	221.36	376.04	0.00	2000.00
• provided by respondents	100.59	244.50	1.00	2500.00
• amount invested by management team	72.30	126.52	0.00	1000.00
Entrepreneur's Equity Stake (EEQUITY)	52.66	21.79	5.00	99.00
Respondent's equity stake (EQUITY)	20.52	18.81	1.00	95.00
Nature of Referral Source (REFERRAL)	3.70	1.28	1.00	5.00
Multi-dimensional construct (TRUST)	12.29	2.26	3.00	15.00
• open/honest disclosure (REL1)	4.16	0.94	1.00	5.00
• ability to deliver on promises (REL2)	4.13	0.79	1.00	5.00
• act in best interests of shareholders (REL3)	4.00	0.92	1.00	5.00
Presence of employee-investor (FULLTIME)	0.39	0.49	0.00	1.00
Control Variables:				
DISTANCE from investor's home base (minutes)	70.29	58.42	1.00	300.00
Venture stage of development (STAGE)	1.87	0.84	1.00	3.00
Dependent Variables:				
Contractual governance (CONTRACT)	5.68	2.05	1.50	10.50
Informal investor interaction (CONTACT) (hrs/mon)	16.77	14.34	0.00	80.00
• face-to-face meetings	7.92	7.78	0.00	40.00
• telephone conversations	4.67	5.71	0.00	40.00
• reviewing written reports	3.49	5.43	0.00	48.00

5.3 Statistical Methodology

In Chapter 4, we developed a number of hypotheses to predict the level of governance effort exhibited by investors both in terms of the: i) contractual safeguards incorporated up front (CONTRACT); and ii) anticipated level of investor interaction with the venture post investment (CONTACT) (summarised as Table 4.1, page 118). Each hypothesis was postulated in correlational terms, for example, H4b stated that: "The greater the number of investments made by an investor, the less intensive the anticipated level of contact with the venture ex post." Thus, multiple regression analysis was used as the basis for hypothesis testing.

The twelve predictor and two control variables were regressed against the two distinct measures of the dependent variable, governance effort (CONTRACT and CONTACT). An examination of regression coefficients for the twelve predictor variables provided the bases for hypothesis testing. Zero-order correlations between the dependent and independent variables will also be presented in Chapter 6 to provide further information and insight.

5.4 Merits and Limitations of Research Design

Merits

The field interview phase of the research design provided the researcher with an in depth personal education into the mechanics of investing in privately-held companies both from the standpoint of investors and entrepreneurs. Insights provided during this phase proved invaluable both in terms of defining a research project that was feasible in scope and of practical relevance.

Second, the survey instrument developed incorporated the insights of both practitioners and prominent researchers in the entrepreneurship field and can be used as a basis for replication studies both within the UK and in other countries. Much of the research which documents the demographics of the informal venture capital market in the UK (Mason, Harrison and Chaloner 1991), Sweden (Landström 1993) and Finland (Suomi and Lumme 1994) were based on a survey design first developed in the US by Wetzel (1981). A recent report (Freear, Sohl and Wetzel 1997) highlighted the need for developing a more informed knowledge base of the terms and conditions of informal venture capital deals; the survey instrument developed in connection with this study should facilitate the process of replication.

Third, the sample selection process was deliberately "catholic" in nature by attempting to tap into as wide a variety of private investors as possible. Many of the previous studies conducted in the UK have sought out the views of investors registered with one of the various business introduction services (Coveney and Moore 1998; van Osnabrugge 1998a; Stevenson and Coveney 1994; Mason, Harrison and Chaloner 1991). There is reason to believe that a sizeable number of private investors choose not to register as part of any service, embedded as they are into their own personal contacts for potential investment opportunities (Kelly and Hay 1998). A number of participants in the pilot phase of this study may fall into this classification. In order to gain a more complete understanding of the informal venture capital phenomenon, it is important to seek out the views of these individuals who may have largely gone unnoticed in previous research.

Fourth, the research design employs a degree of theoretical and statistical rigour to a field of study that is largely unexplored territory. Freear, Sohl and Wetzel (1997) note that the informal venture capital field is entering a stage where: "...researchers seek to transform their interpretation of evidence into explanatory and predictive theories, drawing on their knowledge-base in related fields." (14). Relatively few studies (Norton and Tenenbaum 1993a, 1993b; Fiet 1991, 1995a, 1995b; Landström 1992, 1995; Riding, Duxbury and Haines

1994; Sullivan and Miller 1990; Harrison, Dibben and Mason 1997; van Osnabrugge 1998a, 1999; Landström, Manigart, Mason and Sapienza 1998) have applied theoretical perspectives from other allied fields as a basis for hypothesis development. One of the objectives of this study was to contribute to this growing, albeit small, body of research that will lay the groundwork for developing explanatory and predictive theories.

Limitations

The cross-sectional nature of this research necessarily limits our ability to draw out causal inferences with certainty. Ideally, a far deeper understanding of the issues related to how investors choose to structure their relationship with the entrepreneur could have been achieved by employing a longitudinal design wherein the researcher could unobtrusively observe the behaviour of both parties from the moment that the investor first becomes aware of the investment opportunity to the point where a shareholder's agreement is consummated. The time and financial resources required to implement such a design in practice would prove to be problematic. Moreover, securing access would have also been difficult as informal venture capital inherently involves a large measure of discretion on the part of both investor and entrepreneur.

Second, it would have been desirable to obtain the views of both sides of the investor-entrepreneur dyad. Of necessity, a deal requires the agreement of both parties; seeking out the views of investors only provides a necessarily incomplete picture of the phenomenon.[5] Moreover, obtaining views of both parties in a matched pair design would have substantially enhanced the validity of the information provided; in effect the input of the entrepreneur acts as a check on that provided by the investor, and vice versa. During the pilot phase interviews, while participants were generally willing to provide entrepreneur contact details, concerns were consistently expressed that: i) participating in such a project would be an unnecessary distraction for entrepreneurs; and ii) the views of investors matter most as they alone decide whether to invest and on what terms and conditions.

Third, a larger sample frame would have been desirable for subsequent statistical analysis to enhance our ability to detect underlying relationships. Generalisability of findings is an ever present problem in the area of informal venture capital because the characteristics of the underlying population are "unknown and probably unknowable" (Wetzel 1983). In short, it is simply not possible to assess the representativeness of *any* sample in the absence of any information on the underlying characteristics of the population from which the sample is drawn. Caveats are a necessary condition for any research project in the informal venture capital field irrespective of sample size.

Fourth, because the decision was taken to not modify the survey instrument after completion of the pilot study for fear of antagonising respondents who gave of their time in completing the survey, the opportunity to probe more deeply into a number of interesting issues from the observed data. For example, trustworthy and informative referral sources appear to exert an important influence on the "shape of the deal". It would have been interesting to incorporate a number of questions as to: i) the specific source of the deal flow; ii) whether any of the investors "knew" the entrepreneur personally; and iii) the role the referrer played in helping the investors to assess "the people", for example.

Finally, an obvious limitation of this research design is the potential for biases to occur in the form of: i) self-selection; ii) self-rating; and iii) respondent recall. Self-selection implies that certain individuals are pre-disposed to participate or not participate as the case may be in research projects (Bryman 1989); biases are introduced insofar as certain individuals'

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[5] Although Landström, Manigart, Mason and Sapienza (1998) note that the relative balance of power in the formative stages of the relationship between the entrepreneur and

opinions are over and under-represented respectively. By employing a broadly consultative approach to sample selection, particularly in the pilot study phase, we sought to address this potential source of bias. Whether we were successful in doing so remains an open issue. In choosing to focus on one half of the investor-entrepreneur dyad, the potential for self-rating bias to occur may also be problematic, particularly with respect to the reported level of experience of the contracting parties to the exchange. While it is not possible to assess the degree of bias present with certainty, a significant indicator of consistency was noted in the positive correlation between number of ventures started (NVE#) and reported investor new venture experience (INVEEXP) filtered to exclude those deals which involved a syndicate of investors. Respondent recall bias was addressed by having investors focus on the most recent investment they have made in a venture for the first time. A large majority of the investments (68%) were completed in the last two years. Having said this, self-selection, self-rating and recall biases are ever present and must be taken into account when interpreting subsequent results.

In this chapter, we discussed: i) the reasons why we chose to rely on a survey research design; ii) the steps taken to develop the survey instrument; iii) the approach used to identify a sample of potential respondents; iv) the specification of individual constructs; and v) the proposed methodology to empirically test the model developed in the previous chapter. In the next chapter, we will present the results of our statistical analysis. A broader discussion of some of the findings of our research will be presented in chapter 7. We now turn our attention to the statistical analysis of our data set.

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the investor generally favours the latter.

London Business School Logo

Exhibit 5.1: Survey Instrument

Foundation for Entrepreneurial Management

Private Investor Research Initiative

Over the past four years, the Foundation for Entrepreneurial Management has sought out the views of entrepreneurs with the aim of identifying the barriers which inhibit the growth of small and medium-sized firms in the UK. Based on responses received from more than 3,000 firms, the two major barriers to growth as perceived by entrepreneurs is the inability to raise capital on "reasonable terms" and the loss of control over day-to-day management of the venture implied therein.

With the aim of better understanding under what terms and conditions private investors are prepared to invest in entrepreneurial ventures, London Business School is embarking on a significant research project. We are seeking out the views of active market participants like yourself to see how investors strike the often delicate balance of maintaining "control" over their investment while at the same time providing entrepreneurs with the necessary degree of autonomy to manage the venture day-do-day.

The survey takes no more than 20 minutes to complete and will ask you to comment briefly on the **most recent** investment you have made in a venture **for the first time**. The information provided by you will be maintained **in strict confidentiality** with only summary results being reported. I have also enclosed a self-addressed stamped envelope for your use.

If you would like to be provided with a copy of the research summary, please tick the box below and complete the enclosed form along with the completed survey. Your co-operation in this important research project is sincerely appreciated and please note that **priority access to our investor networking events will be given to those individuals who participate in this project.** If I can be of assistance in the interim, please do not hesitate to contact me directly on (0171) 262-5050, extension 3767.

Contact Address: Peter Kelly, London Business School
Sussex Place, Regent's Park London NW1 4SA

...... please send me a summary report when available

Name/Address: ....

....

....

Tel/Fax: ....

<u>I would best describe myself as someone who:</u>

...... is prepared to invest in private companies but has not done so as yet (in this case, please complete background information part of survey <u>only</u>)

...... has invested in private companies and is looking to make more investments

...... has started a business and wants to be involved in start-ups in a managerial capacity

BACKGROUND INFORMATION

1. How many investments have you made in privately-held, unquoted companies to date?

 ____ investments

2. Have you ever started a business in a managerial capacity on your own or with others?

 YES NO (circle one)

3. If you answered "yes" in question #2, how many ventures have you started?

 ____ ventures

4. Investing in privately-held unquoted companies is inherently risky. Listed below are a number of investment attributes. You are to consider each independently of the other and provide an estimate of the **probability of failure**, where failure implies some real loss of invested capital. Please express your probability as a percentage (%) ranging from 0% (no chance of loss) to 100% (certain loss)

Attribute of the investment	Probability of Failure (%)
Early stage venture	
Management buy-out or buy-in	
High technology venture	
Management lacks experience in the industry in which venture competes	
Management lacks experience running businesses	
Management lacks experience building new businesses	

5. **Investor Control Mechanisms:** The following statements concern issues related to various means by which investor(s) can influence the decisions taken by the entrepreneur/team. Please indicate your agreement or disagreement by checking the appropriate box.

	Strongly Disagree		Neither Agree nor Disagree		Strongly Agree
Terms and conditions of the deal with the entrepreneur team should be as open and flexible as possible	☐	☐	☐	☐	☐
Frequent and informal interaction with the management is a very effective way to manage risk	☐	☐	☐	☐	☐
Active work on the board of directors is a very effective way to manage risk	☐	☐	☐	☐	☐
To ensure that management behaves in the best interests of shareholders contractual safeguards should be included up front	☐	☐	☐	☐	☐

For the questions which follow, we would like you to think about the most recent investment you have made in a venture for the first time. With this investment in mind, please answer the following questions:

1. Date of original investment? ____________

2. **I invested (please select one)**

 ____ on my own
 ____ as part of a group of private investors
 ____ alongside a venture capitalist
 ____ as part of a group of private investors and venture capitalists

3. **Size of Initial Investment: Please give your best estimate of the amount invested in the venture initially**

Initially I personally invested	£ ____________
Other outside investors provided	£ ____________
Management's total investment was	£ ____________

4. **Equity Ownership.** Please give your best estimate for the items below

My share of the business is about	___ %
Other outside investors own about	___ %
Management own about	___ %
Employees own collectively about	___ %
	100%

5. What is the travel time to the venture from your home?

 travel time: ____________________

6. When I first invested, this venture was (**tick one**):

 - ☐ **Startup:** funds required for development and initial marketing (no commercial sales made as yet)
 - ☐ **Early Stage:** funds required to initiate manufacturing and sales (venture may not as yet be profitable)
 - ☐ **Expansion:** funds required to support growth of an existing firm (including turnarounds and bank refinancings)

7. **Industry Classification:** (tick one)

 - ☐ manufacturing
 - ☐ service
 - ☐ distribution

8. Are you a member of the board of directors? YES NO (circle or

Total number of members on board	___ member
Number of manager/employees on board	___ member
Number of investors on board	___ member
Number of outside non-investors on board	___ member

9. **Due Diligence:** The following statements concern issues related to information provided to you by the management team **prior to your deci to invest.** Please indicate your agreement or disagreement by checking t appropriate box.

	Strongly Disagree		Neither Agree nor Disagree		St A
The business plan was comprehensive and well thought out	☐	☐	☐	☐	
Numerous unrealistic assumptions were made in the business plan	☐	☐	☐	☐	
This opportunity was referred to me by a trustworthy source who knew of the individuals involved	☐	☐	☐	☐	
Management committed a substantial proportion of their net worth to the venture	☐	☐	☐	☐	
This is a high-technology venture	☐	☐	☐	☐	

10. Your Relationship With the Entrepreneur: The following statements concern various aspects of the relationship which developed between you and the entrepreneur during due diligence. Please indicate your agreement or disagreement by checking the appropriate box.

	Strongly Disagree		Neither Agree nor Disagree		Strongly Agree
The entrepreneur/team was open and honest in disclosing all relevant information to investors	☐	☐	☐	☐	☐
I trusted this entrepreneur/team to deliver on their promises	☐	☐	☐	☐	☐
I trusted this entrepreneur/team would take decisions in the best interests of all shareholders	☐	☐	☐	☐	☐
I felt that this entrepreneur/team would welcome the involvement of outside investors	☐	☐	☐	☐	☐
From the outset, this entrepreneur/team wanted investor(s) to take an active interest in the venture's development	☐	☐	☐	☐	☐

10. Entrepreneur/Team Experience Base: In your estimation, how much previous experience did the management team bring to the venture in each of the following areas at the time you initially invested.

	No Previous Experience		Some Experience		Extensive Experience
General Management	☐	☐	☐	☐	☐
Relevant industry experience	☐	☐	☐	☐	☐
Sales and marketing	☐	☐	☐	☐	☐
New Venture	☐	☐	☐	☐	☐

Investor Experience Base: In your estimation, how much previous experience did you and other investors as a group bring to the venture in each of the following areas at the time you initially invested.

	No Previous Experience		Some Experience		Extensive Experience
General Management	☐	☐	☐	☐	☐
Relevant industry experience	☐	☐	☐	☐	☐
Sales and marketing	☐	☐	☐	☐	☐
New Venture	☐	☐	☐	☐	☐

11. Competitive Dynamics: The following statements concern various aspects of the competitive domain in which the venture competes at the time of the initial investment. Please indicate your agreement or disagreement by checking the appropriate box.

	Strongly Disagree		Neither Agree nor Disagree		Strongly Agree
This industry was dominated by larger firms	☐	☐	☐	☐	☐
Competitive entry into this industry was relatively easy	☐	☐	☐	☐	☐
How customer needs would change over time was difficult to predict	☐	☐	☐	☐	☐
How the technology used in the industry would change over time was difficult to predict	☐	☐	☐	☐	☐
This venture had a sustainable and defensible position in a profitable market niche	☐	☐	☐	☐	☐
The "window of opportunity" for this venture was quite short	☐	☐	☐	☐	☐

12. Informal Interaction With Venture: For this particular venture, how much time did you anticipate investors would spend on a monthly basis interacting with management and/or the team in the following ways.

Face-to-face meeting (site visits) ___ hours per month

Telephone conversations ___ hours per month

In writing (reviewing reports and plans) ___ hours per month

Are any of the investor(s) employed in the venture on a full or part-time basis?

YES NO (circle one)

If so, how many hours per month would this individual devote to the venture as an employee? ___ hours per month

13. Contractual Provisions: Various provisions can be included which ca serve to protect the interests of shareholders and limit the discretionary behaviour activity of management. For all of the provisions listed, in the hand column, please indicate how important you feel it is to include this specific clause in the shareholders agreement using the following scale Please indicate in the right hand column if this specific provision was included as part of this specific deal.

1 = **Not Important** (almost never included and considered irrelevant)
2 = **Somewhat Important** (often included but considered a matter of housekeeping)
3 = **Very Important** (almost always included and considered a critical means of controlling management behaviour)

Importance Ranking (code 1, 2 or 3)	Provision	Was This Provision Included (tick all that apply
	Investor veto rights over acquisitions and/or divestitures	
	Investor approval required for strategic plans and/or budgets	
	Management can be forced to seek an exit if required to do so by investors	
	Investor approval required to hire and/ or fire senior personnel	
	The level of management compensation must be approved by investors	
	Share options may not be issued without investor approval	
	Non-compete contracts required of management upon termination	
	Investor veto rights over capital expenditure plans	
	Investor(s) countersign cheques above a certain amount	
	Restrictions on the ability to raise additional debt or equity	
	Management equity ratchet provisions are included as part of the deal	
	A specific dispute resolution mechanism is agreed to in writing	

14. Other than discussions about the size of the investor's equity stake in the venture, what issues proved particularly difficult during your negotiations with the entrepreneur/team?

CHAPTER 6: STATISTICAL ANALYSIS AND RESULTS

6.0 Introduction

In Chapter 4, we advanced a number of hypotheses and developed a predictive model relying on the transaction cost economics and agency theory perspectives for guidance (summarised in Table 4.4, page 127). In the previous chapter, the research design, operationalisation of key constructs and the statistical methodology was discussed in detail. In this chapter, we will present the results of our statistical analysis and assess the performance of our models for each of the dependent variables, CONTRACT and CONTACT. In section 6.1, a detailed discussion and analysis of the zero order correlation coefficients between the variables used in this study will be presented. The impact of contextual variables on the nature of contractual safeguards established ex ante (CONTRACT) is assessed in Section 6.2. The performance of the model is then analysed relying on the statistical significance of observed regression beta coefficients as a basis for hypothesis testing. Using a similar logic and analytic procedure, the linkages between contextual variables and anticipated intensity of investor involvement with the venture post investment (CONTACT) will be discussed in Section 6.3. Concluding remarks round out the chapter and appear as section 6.4.

6.1 Observed Zero Order Correlation Coefficients

As evidenced in Table 6.1, multicollinearity does not appear to be a major concern between the predictor variables used in this study; only one of the coefficients exceeds ± 0.50 (STYLE / INVEQUITY: $r=-.530$, $p<.001$) and one other exceeds ±0.40 (EIGMEXP / EINVEEXP: $r=.417$, $p<.001$). A strong negative association between STYLE and INVEQUITY is not altogether surprising as when investors choose to participate alongside other investors, it is reasonable to expect that the individual size of the equity stake retained by participants in the syndicate would be smaller than had they underwritten the investment on their own. One possible way of dealing with this potential source of multicollinearity is to omit one of the variables from our model ex ante, however, we consider both the manner in which the capital is invested and the stake of the respondent in the firm to be distinctly important dimensions worthy of further analysis. Similarly, a strong association between relative levels of general management (EIGMEXP) and new venture (EINVEEXP) experience is not surprising as one can conceivably build a base of the former by working in the context of the latter. In this respect, the two independent variables may be redundant, however, at this point we will include both into our model specifications and will diagnose the extent to which multicollinearity is problematic by examining variance inflation factors (VIF) reported in our regression analysis ex post. Before proceeding with further analysis, a more detailed discussion of the observed zero order correlation coefficients is in order. For consistency, individual variables will be grouped into the respective classification scheme detailed in Chapter 4.

Relative Experience Variables (EIGMEXP; EIINDEXP; EINVEEXP):

To assess knowledge across the investor-entrepreneur interface, we asked respondents to indicate the depth of experience and knowledge that investors and the management team brought to bear in general management positions (EIGMEXP), in a relevant industry context (EIINDEXP), and in the new venture setting (EINVEEXP) respectively. The base of experience of both parties was assessed using identical scales. Our relative experience measure was calculated as the reported experience rating for management divided by that reported for investors on the same dimension.

Measures of management experience are consistently positively associated with one another: EIGMEXP / EIINDEXP (r=.115); EIGMEXP / EINVEEXP (r=.417); and EIINDEXP / EINVEEXP (r=.136). The coefficient between general management and new venture experience is also statistically significant (p<.001). Positive association among the constructs is not altogether surprising as management can conceivably enhance their level of experience on all three measures simultaneously by gaining general management experience in a relevant industry while working in a new venture. Previous research has highlighted that the new venture setting is a fertile learning environment to gain general management experience in view of the often diverse, time sensitive and multi-faceted challenges that are faced, often in a resource constrained environment.

Consistent negative associations are noted between the level of investor experience as an investor (INVEXP) and the three relative experience measures (EIGMEXP: r=-.153; EIINDEXP: r=-.209; EINVEEXP: r=-.101), and, in the case of relative industry experience, the coefficient is statistically significant at the 5% level. Over time, investors can develop a wealth of practical experience dealing with the challenges of building new businesses and growing established ones. As a consequence, it is not surprising to find that the perceived level of experience asymmetry between themselves and management would be reduced as a result of accumulating "hands on" experience over time. Relatively inexperienced investors tend to display a tendency to back "experienced" entrepreneurs, an interpretation consistent with Fiet's conclusion (1995b) that backing experience is a means by which private investors attempt to manage agency risk.

Consistently positive correlation coefficients are noted between the general management (.117), relevant industry (.131) and new venture (.035) relative experience variables and the predictor, ACTIVISM. Positive associations are indicative of a "home run strategy" (Sapienza 1992) in which investors intend to interact most with more experienced entrepreneurs. If ACTIVISM were strictly prompted from a sense of venture needs, one would expect to see negative coefficients between the variables as it is reasonable to expect that, in such situations, the distribution of knowledge and experience should tend to favour the investor as opposed to the entrepreneur.

The correlation coefficients between the relative experience variables and the amount of external capital raised (EXTINV) are consistently negative (EIGMEXP -.001; EIINDEXP -.145, and EINVEEXP -.136). The degree of experience asymmetry between investors and entrepreneurs appears to be lower when larger sums of capital are committed. This makes intuitive sense when one considers that there is a positive and statistically significant association between size of investment (EXTINV) and style of investment (STYLE) ($r=.241$, $p<.01$). Syndicates of investors are more likely involved in funding larger deals and it is reasonable to assume that the cumulative experience of the investing group is greater than if an individual chooses to invest on their own. It follows that the level of experience asymmetry between syndicates and entrepreneurs should be systematically lower than is the case for individual investors. Consistent with this interpretation, all of the observed correlation coefficients between STYLE and relative experience variables are negative (EIGMEXP: $r=-.110$; EIINDEXP: $r=-.039$; EINVEEXP: $r=-.079$). The observed correlation coefficients also lend support to Fiet's (1995b) conclusion that when individuals choose to invest on their own, inherent agency risk is apparently managed by backing experienced entrepreneurs.

The positive associations reported between the inverse of external investment (INVEXTINV) and the relative general management (.020) and new venture (.066) experience predictor variables indicates that investors are prepared to back more experienced people than themselves. However, with respect to relative industry experience, the observed negative coefficient (-.012) supports the view that investors are attracted to opportunities in industries familiar to them. To the extent that smaller deals tend to involve solo investors, an interpretation supported by the negative and statistically significant correlation between

STYLE and INVEXTINV ($r=-.250$, $p<.05$), familiarity with the industry appears to be a necessary prerequisite for investors consistent with the view advanced by Kelly and Hay (1996b).

With respect to the equity stake retained by the respondent in the venture (INVEQUITY), two of the observed correlation coefficients are negative for relative general management ($r=-.035$) and new venture experience ($r=-.180$; $p<.10$). Entrepreneurs who have established a reputation for building new ventures, so called serial entrepreneurs, do appear to have a measure of bargaining power over investors who retain lower equity stakes. This is not altogether surprising in that serial entrepreneurs likely have more sources of finance available to them if their past track record in building new businesses is a long one. The observed positive correlation between relative industry experience and respondent equity stake (.059) supports the view that investors "compensate" for their perceived informational disadvantage vis-à-vis an experienced industry player by retaining larger equity stakes in the venture, although it should be noted that the absolute size of the reported coefficient is small.

A visual inspection of the correlation coefficients between the relative experience variables and the predictor variable, trustworthy REFERRAL source reveals virtually no relationship with relative levels of general management and relevant industry experience. A positive (.120) association with relative new venture experience is noted, however. Knowledgeable and trustworthy referral sources appear to be particularly important to investors in situations where they are dealing with serial entrepreneurs who have more experience building new businesses than do investors. Wrapping their minds around the issue of whether a business can be built on the basis of the opportunity presented appears to be a primary preoccupation for investors and they may look to referrers for guidance in assessing this.

Consistently positive associations are noted with respect to the predictor variable, TRUST (EIGMEXP: $r=.226$; EIINDEXP: $r=.076$; and EINVEEXP: $r=.215$) with relative general management and new venture experience both statistically significant at the 5% level. It would appear that for investors "trust" and "management experience" go hand in hand which lends some measure of credence to the view espoused in the agency literature on reputation effects (see for example Holmstrom 1979, Lambert 1983, Levinthal 1988).

The uniformly positive coefficients observed with respect to the predictor variable, presence of an investor employee - FULLTIME, (EIGMEXP: r=.193, p<.05; EIINDEXP: r=.017; and EINVEEXP: r=.132) are puzzling. If investors are attracted to situations where they can "add value", one would expect to find relatively lower levels of asymmetry in experience between investors and entrepreneurs not higher ones. The only interpretation that can be offered is that investor(s) may choose to build "strength upon strength" interacting closely with very experienced teams to produce a successful outcome, a "homerun strategy" of sorts (Sapienza 1992).

Investor Related Variables (INVEXP; ACTIVISM):

On the basis of completing more private equity transactions, active market participants can accumulate a growing base of experience managing the challenges of building entrepreneurial ventures. Over time, it is also reasonable to suggest that their exposure to, and involvement with, other private investors further broadens their base of experience and insights. Having said this, it is not surprising to see consistently negative correlations between each of the relative experience variables (EIGMEXP -.153; EIINDEXP -.209; EINVEEXP -.101) and our investor experience predictor (INVEXP).

A negative correlation coefficient between investor experience and ACTIVISM (-.020) is not surprising as more active investors likely have larger portfolios to manage and face capacity constraints in being actively involved in any one investment to the detriment of others (Kelly and Hay 1996b). Interestingly, more active investors display a tendency to invest more on their own (STYLE: r=-.171; p<.10) than in syndication with other parties. Over time, investors may become embedded (Granovetter 1985) in deal flow networks, have developed a reputation for "doing deals", may have successfully exited from some private investments, and thus have the cash available and the confidence in their own abilities to assess the merits of proposals and complete them on their own consistent with a line of reasoning advanced by Kelly and Hay (1998).

Individuals who have made more investments in privately held companies tend to make larger investments (EXTINV: r=.193; p<.05) and, not surprisingly, retain lower equity stakes in the venture post investment (INVEQUITY: r=-.072). The observed negative coefficient between INVEXP and the inverse of external investment size (INVEXTINV: r=-.016) is consistent with the view that more experienced investors participate in larger deals and/or that relative novices choose to invest smaller sums on their own in an effort to build up their portfolio and a base of contacts among other investors and potential sources of deal flow alike (Kelly and Hay 1998).

More active investors also appear to gain little information from deal referrers and/or have little practical need for them embedded as they are in numerous sources of potential deal flow as evidenced by the reported negative coefficient between investor experience and REFERRAL (-.091). Experienced investors also appear to be astute judges of character in view of the observed positive correlation with TRUST (r=.045). The negative correlation with respect to predictor variable, presence of an investor-employee - FULLTIME, (r=-.156) is also consistent with the capacity constraints argument advanced above with respect to investor attitudes towards active involvement in the venture's development (ACTIVISM).

Active involvement in the venture development process is particularly viewed as an effective way to manage risks in situations where an investor is backing an experienced management team as evidenced by the positive correlation between ACTIVISM and all of the relative experience predictors (EIGMEXP: r=.117; EIINDEXP: r=.131; EINVEEXP: r=.035). Presumably, working most intensively with the most experienced entrepreneurs may enhance the probability of the venture succeeding and in doing so, minimise the level of perceived risk for investors. Perceptions of utility are impacted, however, by the capacity of the investor to devote time to the venture constrained as some are by the size of their portfolios as evidenced by the negative correlation between ACTIVISM and INVEXP (-.020).

The observed negative and statistically significant correlation between STYLE and ACTIVISM (r=-.167, p<.05) indicates that solo investors are particularly active managers of risk as they have no one else to share the monitoring load with. Moreover, as solo investors are typically involved in situations where relatively smaller sums of capital are at risk *and* the venture is in the very early stages of development, the need for active involvement is probably greater and the impact far more reaching than may be the case in more established ventures. This line of interpretation is further supported by the observed correlation coefficients between ACTIVISM and EXTINV (-.063) and INVEXTINV (.093); active involvement appears to be viewed as a more effective risk management strategy in early stage ventures where relatively small sums of capital are placed at risk, consistent with the venture needs hypothesis (Landström 1992).

The positive association between ACTIVISM and respondent equity stake (INVEQUITY) (r=.163, p<.10) lends support for the view that managing risk in an active "hands on" manner appears to be a direct function of the investor's stake in the outcomes, consistent with both the transaction cost and agency theory perspectives. Investor's attitudes on the effectiveness of active involvement as a risk management tool appears to bear little relationship to the nature of the REFERRAL source (r=.044). However, the positive correlation between ACTIVISM and the predictor variable TRUST (r=.109) implies a relationship between the parties that can be characterised as a working partnership based on mutual trust. One might reasonably expect to see a stronger positive association between ACTIVISM and

FULLTIME as employment in the venture is one possible means for investors becoming involved. The relatively low positive correlation ($r = .032$) while bearing the expected sign is further indication of possible capacity constraints faced by investors in making the time commitment to be employed in the business in some capacity.

Deal Attribute Variables

Investment Style (STYLE)

Not surprisingly, syndicates of investors collectively bring greater experience to the table vis-à-vis management than do investors who choose to invest on their own. This interpretation is borne out by the observed negative correlations between STYLE and all of the relative experience predictors (EIGMEXP: $r=-.110$; EIINDEXP: $r=-.039$; EINVEEXP: $r=-.079$). Syndication also appears to be an attractive option for less active investors who are trying to build a portfolio (INVEXP: $r=-.171$, $p<.10$) with one of the apparent benefits being that the monitoring work load can be shared among a group of individuals as opposed to being borne by the investor alone as evidenced by the negative (-.167) and statistically significant ($p<.05$) correlation between STYLE and ACTIVISM, consistent with a line of reasoning advanced by Kelly and Hay (1996b).

Relatively larger sums of capital are invested by syndicates of investors as evidenced by the positive (.231) and statistically significant ($p<.05$) correlation between EXTINV and STYLE. Solo investors appear to tread most commonly in ventures that require relatively small sums of capital, the observed correlation coefficient between STYLE and INVEXTINV ($r=-.250$, $p<.05$) is consistent with this interpretation. STYLE and respondent equity stake retained (INVEQUITY) are strongly negatively (-.530) and significantly ($p<.001$) related as can be reasonably expected for two reasons. First, individual participants in a syndicate must proportionately share the equity surrendered with other syndicate partners, usually on the basis of capital contributed. Second, to the extent that smaller investments are made at earlier stages of development *and* that these investments are usually made by individual investors on their own, one can reasonably expect that relatively larger equity stakes would need to surrendered by the entrepreneur.

There is virtually no relationship between STYLE of investment and trustworthy REFERRAL source ($r=-.004$) as one might reasonably expect. The negative coefficient reported between STYLE and TRUST ($r=-.052$), albeit small, may lend further credence to the view that some investors who participate in syndicates may not personally undertake as much due diligence as they might have done had they been investing on their own. Moreover, syndicates afford the opportunity to "share the due diligence workload" among a group of individuals. It also may facilitate the ability of one or more of the syndicate members to assume an employment position in the venture. The positive correlation between STYLE and FULLTIME ($r=.167$; $p<.10$) is consistent with this interpretation.

Level of External Investment (EXTINV; INVEXTINV)

The greater the level of capital invested (EXTINV), the more experience, particularly in a relevant industry (-.145) and in the new venture setting (-.136), investors are looking for in the management team. With a base of deals completed, active investors (INVEXP) appear to participate in bigger investments ($r=.193$, $p<.05$) perhaps a reflection of being deeply integrated into numerous sources of deal flow (Kelly and Hay 1998) *and/or* having disposable funds available as a result of successfully achieving exit on some of the investments in their portfolio. The capacity to be actively involved appears to be hampered by portfolio size as evidenced by the negative correlation between EXTINV and ACTIVISM ($r=-.063$). One of the key benefits of investing as part of a syndicate is the ability to underwrite larger deals as evidenced by the positive (.241) and statistically significant ($p<.05$) correlation between EXTINV and STYLE. The impact of syndication is also felt in the form of relatively lower equity stakes retained by individual investors as evidenced by the negative correlation between EXTINV and INVEQUITY (r=-.042).

Trustworthy and knowledgeable REFERRAL sources are particularly important in larger deals (r=.229, p<.05) which is not altogether surprising as with more capital at risk, investors could be expected to pay more attention to and pursue all available sources of information about the opportunity during due diligence. A small "measure of distrust" is evident in larger deals insofar as the observed correlation between EXTINV and TRUST is negative (r=-.024) although the absolute size of coefficient is small. As a means of providing oversight when large amounts of capital are invested, investors may choose to become involved with the venture in an employment capacity as evidenced by the positive correlation between EXTINV and FULLTIME (r = .055).

Smaller deals (INVEXTINV) appear to be different in a number of respects. First, investors do appear to back proposals from more experienced people than themselves particularly in business (r=.020) and in new ventures generally (r=.066). Smaller deals also imply the active involvement (ACTIVISM: r=.093) of relatively inexperienced investors (INVEXP: r=-.016) who are attempting to: i) build their portfolio, and ii) learn how best to manage risk by being "hands on". Less sizeable transactions are also the domain for solo investors as evidenced by the negative and statistically significant correlation between INVEXTINV and STYLE (r=-.250, p<.05). Not surprisingly, by typically investing smaller amounts on their own, investors can retain relatively larger personal equity stakes in the venture post investment (r=.102). Inexperience also manifests itself in an apparent inability to judge the trustworthiness of the REFERRAL source (r=-.049) with virtually no relationship observed between INEXTINV and TRUST in the management team (r=.007). Moreover, smaller deals appear to involve ventures with specific development needs as evidenced by the positive association between INEXTINV and FULLTIME (r=.070).

Investor's Equity Stake (INVEQUITY)

Management experience, particularly in the new venture setting (EINVEEXP: $r=-.180$, $p<.10$), is valued by investors who retain relatively smaller stakes in the business post investment. Investor's relative lack of relevant industry experience vis-à-vis the management team appears to be "compensated" by retaining relatively larger equity stakes (EIINDEXP: $r=.059$). The positive association between ACTIVISM and respondent equity stake ($r = .163$, $p < .10$) lends support for the view that managing risk in an active "hands on" manner appears to be a direct function of the investor's stake in the outcomes, consistent with both the transaction cost and agency theory perspectives. Bigger deals with more syndicate partners implies relatively lower stakes for individual syndicate participants, for reasons noted above with respect to investment size, as evidenced by the negative (-.530) and highly significant ($p<.001$) correlation coefficient between INVEQUITY and STYLE. Investing on their own, in smaller amounts and at earlier stages of development does imply the retention of relatively larger equity stakes for investors (INVEXTINV: $r=.102$).

A negative correlation between trustworthy REFERRAL source and INVEQUITY ($r=-.056$), while statistically insignificant, lends support for the view that the nature of the referral source matters. To the extent that deal referrers possess useful (agency risk reducing) information for potential investors, lower equity stakes are retained by investors. The positive association between INVEQUITY and the predictor variable TRUST ($r=.231$; $p<.05$) lends support for the assertion that interpersonal trust is a necessary ingredient for the deal to happen at all. This may be particularly so in the precarious early stages of the venture's development when an investor is typically investing on their own and retains relatively larger equity stakes until such time as further capital injections (and associated dilution) are secured. The negative coefficient between FULLTIME and INVEQUITY ($r=-.147$) lends some measure of support for Sullivan's (1994) conclusion that investors are prepared to trade off relative equity stakes for other perceived benefits such as employment in the venture.

Nature of Referral Source (REFERRAL)

A visual inspection of the correlation coefficient matrix reveals that knowledgeable and trustworthy referral sources do have an important influence on investors in assessing the experience of the management team in building new ventures (EINVEEXP: $r=.120$) and, in particular, for larger deals (EXTINV: $r=.220$, $p<.05$). The nature of the REFERRAL source does appear to shape investor's perceptions as to the trustworthiness and integrity of the entrepreneur in favourable ways as evidenced by the positive (.187) and statistically significant ($p<.05$) correlation between REFERRAL and TRUST. The positive association between REFERRAL and FULLTIME ($r=.070$) indicates that deal referrers may be particularly helpful to investors in addressing issues related to the compatibility of the parties to work closely together and the receptivity of the entrepreneur for such close co-operation in the first place.

Interpersonal Trust (TRUST)

Extensive previous management experience in business (EIGMEXP: $r=.226$, $p<.05$) and in new ventures ($r=.215$, $p<.05$) appear to be formative elements in investor's minds as to the perceived trustworthiness of the proponents. The greater the base of experience a team brings, the greater is the basis for an investor to conclude that the proponents can be trusted to act in their interests, a line of reasoning thoroughly consistent with the growing literature modelling reputation effects. Investor impressions of the trustworthiness of the other party are also more important the more active the investor is inclined to be in the venture development process as evidenced by the positive correlation ($r=.109$) between ACTIVISM and TRUST. The investor's perception of trust comes into much clearer focus when they maintain a relatively larger share in the outcomes (EXTINV: $r=.231$, $p<.05$) and these perceptions appear to be shaped by the nature of the referral source used (REFERRAL: $r=.187$, $p<.05$).

Presence of an Investor-Employee (FULLTIME)

Building upon the strengths of an experienced management team, investors appear to involve themselves more intimately with the venture in an employment capacity as evidenced by the observed correlation coefficients between FULLTIME and EIGMEXP ($r=.193$, $p<.05$) and EINVEEXP ($r=.132$). Presumably, investors seek to interact with the most experienced teams in a more intensive manner in the view that these ventures have the greatest potential for future success, consistent with a "home-run strategy" (Sapienza 1994). The investor capacity argument is supported by the observed negative correlation between FULLTIME and INVEXP ($r=-.156$). Active market participants do not appear to have the time available to devote to any one venture to the exclusion of others in their portfolio. Having said this, syndicates afford the opportunity to share the monitoring work load as evidenced by the positive (.167) and statistically significant ($p<.10$) correlation between FULLTIME and STYLE. Private investors may not be solely motivated by financial rewards as it appears they are willing, in some cases, to trade off larger equity stakes in a venture for being employed in some capacity, consistent with a line of reasoning advanced by Sullivan (1994). Involvement of an investor as an employee does bring some measure of comfort to investor(s) as the observed positive association between FULLTIME and TRUST would indicate ($r=.112$).

Intercorrelations Between Dependent Variables

In this study, two measures of governance effort, CONTRACT and CONTACT, have been developed to capture the nature of the contractual deal struck with the entrepreneur and the intensity of contact (face-to-face meetings, telephone calls, reviewing reports) investor(s) maintain with the venture respectively. The two dependent variables are positively associated ($r=.168$) and statistically significant ($p=.089$). This finding makes intuitive sense insofar as explicit contracts may create an ongoing need for contact with the entrepreneur (for example, spelling out in detail how frequently the board meets, the nature of monthly reports to be provided to investors, etc.). Of greater importance, is that the magnitude of positive association is not overly high, an indicator that the two dependent variables are tapping into distinct dimensions of the concept, governance effort. Put another way, there is no reason to believe that the two dependent variables can be combined into a single measure without the loss of information.

6.2 Impact of Context on the Nature of the Contractual Deal (CONTRACT)

We argued in Chapter 4 that various characteristics of the contracting parties and the deal itself will influence the choices investors make with respect to the nature of the contractual deal (CONTRACT) struck with the entrepreneur. The expected relationships between the independent variables and the dependent variable, CONTRACT are summarised in Table 6.2 below:

Table 6.2: CONTRACT Model Summary

VARIABLES	Predicted Sign	Hypothesis
Relative Experience Predictors:		
Relative New Venture Experience (EINVEEXP)	+	H1a
Relative Relevant Industry Experience (EIINDEXP)	+	H2a
Relative General Management Experience (EIGMEXP)	+	H3a
Investor Related Predictors:		
Experience as an Investor (INVEXP)	-	H4a
Active Involvement as Risk Management Tool (ACTIVISM)	+	H5a
Deal Attribute Predictors:		
Style of Investment (STYLE)	0	H6a
Size of Investment (EXTINV)	+	H7a
Inverse of Investment Size (INVEXTINV)	+	H8a
Respondent Equity Stake (INVEQUITY)	+	H9a
Nature of Referral Source (REFERRAL)	-	H10a
Interpersonal Trust (TRUST)	-	H11a
Presence of Investor-Employee in Venture (FULLTIME)	-	H12a
Control Variables:		
Travel Time From the Venture (DISTANCE)		
Venture Stage of Development (STAGE)		

Results

In table 6.3, we present the results of regressing the twelve predictor and two control variables (STAGE and DISTANCE) against the level of contractual governance (CONTRACT) established by investors. As explained in the previous chapter, investors were provided with a list of twelve contractual provisions and were asked to: i) rate the importance of including each as part of the shareholder's agreement on a three- point Likert scale ("irrelevant" = 1; "somewhat important" = 2; and "very important" = 3) and ii) indicate which provisions were actually included in the deal with the entrepreneur (not included = 0; included = 1). A single measure, CONTRACT was developed by assigning weights to the importance rankings ("irrelevant" = 0.25; "somewhat important" = 0.50; "very important" = 1.00) and multiplying each by the value of the dummy variable that captured inclusion. On this basis, the CONTRACT measure could range from 0 (no provisions were included) to 12 (all of them were included *and* all were rated as being "highly important").

Seven of the twelve standardised beta coefficients have the expected signs and of these seven, five are also statistically significant. Almost 40% of the observed variance in the dependent variable, CONTRACT, is explained by our model (R^2=.389). As we are relying on the reported beta coefficients as a basis for testing hypotheses, each of the coefficients will be discussed in turn.

Relative Experience Predictor Variables

Among the relative experience predictor variables, only one - relative industry experience (EIINDEXP) - had both the expected sign (.181) and was statistically significant ($p<.05$). For the three variables that captured the relative experience of the management team as compared to the investor(s), we maintained that, consistent with the transaction cost and agency perspectives, the threat of opportunism is greater in situations where the relative experience base of the contracting parties favours the entrepreneur. We argued that investors could deal with the threat of opportunism by restricting or directing the behaviour of the entrepreneur by including specific provisions ex ante as part of the shareholder's agreement. Greater relative industry experience on the part of the entrepreneur (EIINDEXP) appears to be an important reason why investors place a great deal of importance on contractual safeguards and include more of them up front. Interestingly, what attracts an investor to a specific individual, an extensive base of relevant industry experience, is also the source of greatest concern for them in attempting to manage risk. On this basis, **hypothesis 2a** is **supported.**

The negative standardised beta coefficients reported for relative new venture (EINVEEXP: -.007) and general management (EIGMEXP: -.027) experience, while small in magnitude, may reflect one of two things. First, investors may accord some measure of "value" to experience insofar as experienced management teams can secure somewhat more "favourable" contractual terms from them. From the perspective of an entrepreneur, we maintain that a "favourable" deal is one that includes fewer contractual safeguards and thus fewer perceived investor controls over the venture. We examined the partial correlation coefficients between the entrepreneur's experience base and the dependent variable CONTRACT. If this line of reasoning holds, we should see statistically significant negative correlation coefficients. Our analysis revealed that virtually no relationship was evident for general management (EGMEXP) and new venture (ENVEEXP) experience. The observed correlation coefficient for relevant industry experience (EINDEXP) is negative (-.053) but statistically insignificant.

Alternatively, the balance of experience may tend to favour investors who bring more experience in business generally and in the new venture setting in particular to the table than does the entrepreneur. Moreover, they use this experience advantage to secure the deal "on their terms". From Table 5.4 (page 139), we note that investors do consider their base of experience in general management positions and the new venture setting do exceed those reported for management. Our analysis of the data also indicates that there is remarkable consistency between the perceived importance of including a specific provision and its actual inclusion by investors, indicative that on these issues at least it appears entrepreneurs have little negotiating latitude. In the chapter that follows, we will highlight in more detail the nature of the contractual deal that is struck with entrepreneurs. On this basis, **hypotheses 1a and 3a** are **rejected**.

Investor Related Predictor Variables

We expected that more experienced investors would adopt a more parsimonious approach to contracting by including fewer contractual safeguards up front consistent with hypothesis 4a. The reported positive (.071) standardised beta coefficient between our investor experience (INVEXP) predictor and the dependent variable CONTRACT was unexpected. A possible explanation for this finding is that experienced investors tend to invest in larger sums as evidenced by the strongly positive ($r=.193$) and statistically significant ($p<.05$) coefficient of correlation between INVEXP and size of external investment (EXTINV) from table 6.1. With greater capital at risk, experienced investors have more to lose. Our findings are also consistent with a line of reasoning advanced by van Osnabrugge (1998a) that investors become more cautious contractors as they personally experience the problems and potential losses associated with building entrepreneurial ventures. On this basis, **hypothesis 4a** is **rejected**.

Generally speaking, private investors are inclined to be active participants in the venture development process (Harrison and Mason 1992b; Mason, Harrison and Allen 1995). In addition to being a key non-financial motivation for investment (Wetzel 1994), investors appear to consider active involvement to be an effective means of managing the business and agency risks associated with investing in privately and closely-held firms. Our respondents strongly agreed with the statement that "informal and frequent interaction with management is an effective means of managing risk" (mean 4.46 on a five-point scale with 5 = "strongly agree"). Consistent with hypothesis 5a, we maintained that active involvement implies greater attention be paid to specifying the rights, obligations and respective roles of the parties to the deal. The positive (.184) and statistically significant ($p<.05$) standardised beta between ACTIVISM and the dependent variable CONTRACT supports this interpretation. Our findings also lend further credence to the observation of Landström, Manigart, Mason and Sapienza (1998) that contracts serve a useful purpose in establishing the parameters of the relationship between investor and entrepreneur. On the basis of our data, **Hypothesis 5a** is **accepted.**

Deal Attribute Predictor Variables

We maintained that there should be no relationship between mode of investment (STYLE) and our dependent variable CONTRACT. The observed positive (.358) and highly significant ($p<.01$) standardised beta coefficient lends strong support for the view that syndicated investments may pose potential contracting problems for investors. To the extent that syndicated deals involve the commitment of larger sums of capital, greater attention needs to be paid to implementing effective contractual safeguards as investors stand more to lose in an absolute sense. Moreover, it appears that individual investors need to clarify their rights and obligations with their investor partners *as well as* with the entrepreneur. In this respect, our findings lend further support for the view advanced by Landström, Manigart, Mason and Sapienza (1998) that individual investors bring their own unique perspectives and opinions to bear on how the deal is eventually documented. The larger the number of individuals involved, the more comprehensive the contractual deal that is struck with the entrepreneur to reflect all of the individual syndicate members' views. On this basis, we **reject hypothesis 6a**.

Consistent with hypothesis 7a, when larger sums of capital are invested, investors do incorporate more contractual safeguards up front as evidenced by the positive standardised beta coefficient between EXTINV and CONTRACT (r=.153). **Hypothesis 7a** is thus **supported**. We also maintained that smaller deals are also problematic for investors insofar as numerous gaps in the management team may exist and the venture may be in the very early stages of development and thus facing numerous technological, market and competitive uncertainties. In such circumstances, the experience of investors is most valued and needed and their involvement in the venture's development most wanted by the entrepreneur. A degree of contractual specificity is implied consistent with hypothesis 8a. The positive (.224) and statistically significant ($p<.05$) standardised beta coefficient between INVEXTINV and CONTRACT lends **support** for **Hypothesis 8a.**

In situations where the investor has a large equity stake in the venture, we argued that they would, in turn, bear a disproportionately large part of the implied costs associated with sub-optimal behaviour on the part of the entrepreneur. Put another way, the greater is the investor's stake in the outcome, the greater is the incentive for them to protect and actively promote their interests as shareholders. A highly significant ($p<.01$) and positive (.287) beta coefficient between INVEQUITY and the dependent variable CONTRACT lends **strong support** for **Hypothesis 9a**.

We also maintained that, consistent with Hypothesis 10a, the source of deal referral matters. Insofar as a deal referrer has personal information and knowledge of the proponents involved *and* is someone whose judgement and opinion the investors trusts, entrepreneurs can secure finance on "more favourable terms". By "more favourable", we mean that entrepreneurs are granted more "degrees of freedom" by the investor as fewer contractual safeguards are included up front. The highly significant ($p<.01$) negative (-.289) beta coefficient reported between REFERRAL and the dependent variable CONTRACT lends **strong support** for **Hypothesis 10a**.

Based on Hypothesis 11a, we maintained that greater levels of interpersonal TRUST between the parties would influence the nature of the contractual deal struck ex ante in favourable ways for the entrepreneur. The reported beta coefficient is negative as expected but statistically insignificant and relatively small in magnitude (-.029). It appears that TRUST has a limited direct impact on the choices investors make as to the nature of the contractual deal agreed to with the entrepreneur. On this basis, we have grounds to **reject Hypothesis 11a**. While displaying no direct effect, we examined whether TRUST had a moderating impact on any of the other predictor variables in the model. We introduced an interaction term between TRUST and a given predictor variable in a step-wise regression and examined the impact of including this term on the reported standardised beta coefficients for the relevant predictor variable, TRUST and on the interaction term itself. On the basis of this analysis, we concluded that TRUST **did not moderate** any of the other observed relationships between individual predictor variables and the dependent variable CONTRACT.

Finally, we maintained, consistent with Hypothesis 12a, that the presence of an investor-employee should mitigate the need to build in elaborate contractual safeguards ex ante. Contrary to expectations, the reported beta coefficient is positive (.111) which indicates that more explicit attention to contractual detail is required to clarify and separate the role of these investors as "employees" and "investors" particularly with respect to syndicated investments. On this basis, **Hypothesis 12a** is **rejected.**

Control Variables

In order not to confound subsequent analysis, two control variables were introduced, venture STAGE of development and travel time to the venture from the investor's home base of operations (DISTANCE). A positive beta coefficient between STAGE and CONTRACT (.070) implies that later stage deals involve a greater degree of contractual specificity, not altogether surprising as these types of transactions often involve the commitment of larger amounts of funds (r=.292, p<.01) and involve syndicates of investors (r=.260, p<.01). The observed positive beta coefficient between CONTRACT and the other control variable, DISTANCE, (.123) also makes intuitive sense as greater distance creates effective barriers to interaction. It appears that investors compensate for this inability to manage their investments in as "hands on" manner as they make like by paying more attention to the nature of the contractual safeguards incorporated into the deal ex ante.

In Summary

On the basis of empirically testing the model developed to explain the determinants of the nature of the contractual deal struck with the entrepreneur ex ante, we have uncovered a number of important effects. As anticipated, a greater degree of contractual specificity is implied in situations where: i) the management team has more relevant industry experience than do investors; ii) investors consider active involvement to be an effective means of managing risk; iii) relatively large and especially small sums of capital are at risk; and iv) the investor's relative stake in the outcomes is large. Investments that involve a syndicate of investors appear to pose significant contracting difficulties and imply greater care and attention to specifying the contractual rights of all parties to the deal. The nature of the referral source does matter. In situations where a deal is referred on to investors by a source that is both informative and trustworthy in their minds, fewer contractual safeguards are included ex ante. Interestingly, the level of interpersonal trust the investor has in the entrepreneur bears no relationship to the dependent variable CONTRACT.

6.3 Impact of Context on the Anticipated Level of Investor Contact With the Venture

In Chapter 4, we maintained that both the nature of the contractual deal struck with the entrepreneur (CONTRACT) and the anticipated level of investor involvement with the venture (CONTACT) are influenced, in large measure, by a similar set of underlying characteristics of the contracting parties and specific attributes of the investment itself. In our model formulation, our dependent variable CONTACT was a composite of three items which measured the anticipated level of investor contact with the venture (hours per month): i) in face-to-face meetings; ii) speaking on the telephone with the entrepreneur; and iii) reviewing written reports and documents submitted to them. Investor involvement in an employment capacity was excluded from our measure of CONTACT. The expected relationships between the independent variables and the dependent variable, CONTACT are summarised as Table 6.4 below:

Table 6.4: CONTACT Model Summary

VARIABLES	Predicted Sign	Hypothesis
Relative Experience Predictors:		
Relative New Venture Experience (EINVEEXP)	+	H1b
Relative Relevant Industry Experience (EIINDEXP)	+	H2b
Relative General Management Experience (EIGMEXP)	+	H3b
Investor Related Predictors:		
Experience as an Investor (INVEXP)	-	H4b
Active Involvement as Risk Management Tool (ACTIVISM)	+	H5b
Deal Attribute Predictors:		
Style of Investment (STYLE)	0	H6b
Size of Investment (EXTINV)	+	H7b
Inverse of Investment Size (INVEXTINV)	+	H8b
Respondent Equity Stake (INVEQUITY)	+	H9b
Nature of Referral Source (REFERRAL)	-	H10b
Interpersonal Trust (TRUST)	-	H11b
Presence of Investor-Employee in Venture (FULLTIME)	-	H12b
Control Variables:		
Travel Time From the Venture (DISTANCE)		
Venture Stage of Development (STAGE)		

Results:

In Table 6.5, we present the results of regressing the twelve predictor and two control variables (STAGE and DISTANCE) against the anticipated level of investor contact (CONTACT) with the venture. Six of the twelve standardised beta coefficients have the expected signs and of those, four are statistically significant. In excess of 40% of the observed variance in the dependent variable, CONTACT, is explained by our model (R^2=.418). As we are relying on the observed beta coefficients as a basis for testing individual hypotheses, we shall discuss each of them in turn.

Relative Experience Predictor Variables

In Chapter 4, we argued that the potential for opportunistic behaviour on the part of the entrepreneur to occur is greatest in situations where the team brings relatively more experience to bear than do investors working in: i) the new venture setting (H1b); ii) a relevant industry context (H2b), and iii) general management positions (H3b). To deal with this threat, the transaction cost and agency perspectives contend that investors can build in contractual safeguards ex ante and/or monitor the behaviour of entrepreneurs ex post by maintaining close contact with the venture. We should expect to see positive beta coefficients between all of the relative experience variables and the dependent variable CONTACT consistent with hypotheses 1b to 3b inclusive.

Contrary to expectations, all of the relative experience predictor variables displayed negative coefficients (EINVEEXP -.074; EIINDEXP -.040 and EIGMEXP -.116). One possible interpretation of this result is that the level of contact between investor(s) and the entrepreneur is motivated not by a sense of investors "protecting their interests" but rather as a function of venture need. Previous research in the informal venture capital area has consistently demonstrated that a major motive for investment is the opportunity for investors to "add value" beyond the provision of capital. While it is not possible to directly compare coefficients, the relative magnitude of the differences is also broadly supportive of the findings of previous research (Harrison and Mason 1992b, Mason and Lumme 1995) which concluded that, in the opinion of investors, the major contributions they bring to a venture's development are general business and hands on experience building new businesses. Further analysis of the data also revealed that the anticipated investor contact with the venture was lower in situations where the team brought greater experience in the new venture setting ($r=-.171$, $p<.10$) thoroughly consistent with the line of reasoning that the need for close investor involvement with experienced contractors is mitigated. Similarly, in situations where the investors had much general business experience upon which to draw, more contact was expected with the venture post investment ($r=.176$, $p<.10$). The findings of our study support the view of 3i (1994) that concluded that general business experience was one of the key intangible contributions an investor can make to the development of a venture. Landström (1992) called into question the utility of using an agency theoretic approach in the informal venture capital area as the relationships between investor and entrepreneur displayed a much more "positive character" than the theory would suggest. Monitoring thus is not viewed as a means of protecting one's interest but in promoting one's interests for the good of all parties to the exchange.[1] In this respect, the results of testing our model lend further support to Landström's conclusions. On this basis, we **reject Hypotheses 1b, 2b and 3b.**

Investor Related Predictor Variables

We also maintained that investors who have completed numerous private investments stand to benefit from their own experience of knowing when it is most appropriate to interact with the venture and how to effectively and efficiently manage their relationship with the

[1] Although the distinction to be drawn between promoting one's interest and protecting it is a fine one.

entrepreneur. To the extent that experienced investors also have larger portfolios to manage, they may be practically constrained to closely interact with a given venture to the exclusion of others in their portfolio. Consistent with this line of reasoning, we observe a negative beta coefficient between INVEXP and CONTACT (-.041), however the finding is statistically insignificant. Why might the magnitude of the observed coefficient not be as large as we expected? Further analysis of the data set revealed that very active investors tend to participate in bigger deals; the correlation coefficient between INVEXP and EXTINV is positive (.205) and significant ($p<.05$). As larger sums of capital are typically invested in later STAGE deals ($r=.292$, $p<.01$), the need for close investor interaction is mitigated and thus a negative beta coefficient between INVEXP and CONTACT should be expected. This effect appears to be offset, somewhat, by the fact that experienced investors displayed remarkable conviction to backing early stage proposals where the development needs of the venture are likely greater, and thus the need for close investor interaction more acutely felt. In excess of 70% of the deals reviewed were early stage proposals with virtually an identical proportion of non-serial and serial investors participating. On this basis, we conclude that **Hypothesis 4b is supported in sign only.**

To the extent that investors consider active involvement in the venture development process to be an effective means of managing risk, this should be reflected in higher anticipated levels of contact with the venture post investment consistent with hypothesis 5b. Generally speaking, our respondents did consider informal and frequent interaction with management to be a very effective risk management tool as evidenced by their strong level of agreement to a question that sought out their views on this issue. From Table 5.4 (page 139), we note that the mean rating was 4.46 on a five-point scale with 5 representing "strongly agree". Intense interaction appears to be a means for investors to promote, and in doing so, protect their interests as shareholders. On this basis, the positive (.214) and statistically significant ($p<.05$) beta coefficient between ACTIVISM and CONTACT lends **support** for **Hypothesis 5b.**

Deal Attribute Predictor Variables

In terms of mode of investment (STYLE), we did not expect to observe any relationship with anticipated level of investor CONTACT consistent with hypothesis H6b. A statistically significant negative beta coefficient (-.197, $p<.10$) is noted between STYLE and the dependent variable CONTACT. One possible explanation for the observed negative beta is that investors who choose to invest on their own are solely responsible for monitoring developments in the venture having no one else to share the workload with. Coupled with the fact that solo investors typically invest in smaller amounts ($r=.241$; $p<.05$) and at earlier stages of development ($r=.266$; $p<.001$) implies that the need for close investor involvement is more acutely felt in these situations than is the case for a more developed venture. The null hypothesis **(H6b)** that there is no relationship between mode of investment and anticipated level of contact is **not supported**.

With relatively greater sums of capital at risk, we expected to see a positive beta between level of investment (EXTINV) and CONTACT. Consistent with hypothesis 7b, the standardised beta coefficient between the variables is positive (.019) albeit small in magnitude. Typically larger deals involve a syndicate (EXTINV / STYLE: $r=.241$, $p<.05$) backing a venture in a later STAGE of development ($r=.292$, $p<.01$), as such it is feasible to undertake more due diligence as a group than if someone had chosen to invest on their own. While syndicated investors did spend 50% more time, on average (18 hours per month) interacting with later as opposed to early stage ventures, they spent significantly less time interacting with more developed ventures than solo investors (27 hours on average). It is noteworthy that in almost 30% of the early stage deals reviewed, the size of external investment exceeded £500,000 with three exceeding £1 million. On the basis of testing our model, **Hypothesis 7b is supported in sign only**.

When smaller sums of capital are at risk (INVEXTINV), we argued that the need for close investor involvement with the venture is probably more acutely felt and desired by the entrepreneur. A highly significant ($p<.001$) positive (.338) beta coefficient between the inverse of investment size and CONTACT is noted lending **very strong support** for **Hypothesis 8b**. Our findings are thoroughly consistent with a line of reasoning advanced by Sahlman (1990) with respect to investors committing increased levels of funding to ventures based on the achievement of significant milestone development targets. With the passage of time, the entrepreneur develops a broader base of experience, both as a general manager and in a particular industry setting, an interpretation supported by the observed positive correlation coefficients between level of investment (EXTINV) and the entrepreneur's general management ($r=.205$; $p<.05$) and relevant industry ($r=.128$) experience. The need for interaction is greatest in the relatively early stages where gaps in the management team may exist and, therefore, the base of experience may be quite limited. Further analysis of the data set supports this interpretation as the reported experience base of the team in general management positions and a relevant industry was lower for seed and early stage ventures as compared to later stage ones.

Consistent with both the transaction cost and agency theory perspectives, investors who retain relatively large equity stakes in the venture (INVEQUITY) stand to bear a disproportionately large amount of the implied costs of sub-optimal behaviour on the part of the entrepreneur. One possible way of protecting their interests is to closely interact with the venture post investment. We expected to find a positive association between level of respondent equity stake and anticipated level of contact. Our findings provide **support for Hypothesis 9b** on the basis of the observed positive (.189) and statistically significant ($p=.07$) beta coefficient between INVEQUITY and CONTACT. With a greater stake in the outcome, investors appear to have an incentive to ensure that their interests are protected and promoted. Interestingly, the effect is not as strong as agency theory or transaction cost economics would suggest lending further credence to the belief that the relationship between the parties is more positive in character than either perspective would suggest (Landström 1992).

On the face of it, knowledgeable and informative REFERRAL sources who are trusted by the investor can be a useful "first check" in dealing with the problems of self selection and moral hazard on the part of the proponents seeking finance. Contrary to expectations, a positive (.041) albeit statistically insignificant beta coefficient is observed between REFERRAL and CONTACT. One possible explanation for this finding is that trusted deal referrers may be uniquely positioned to send credible signals to the entrepreneur that investor involvement is well intentioned and to the investor that their involvement is welcomed. This line of reasoning lends further support behind Landström's (1992) notion that the relationship between the parties is more positive in character than agency theory, in particular, would suggest. On this basis we **reject Hypothesis 10b**.

Does the level of interpersonal trust that exists between the parties matter in terms of the anticipated level of investor interaction post investment? The negative (-.178) and statistically significant ($p<.05$) beta coefficient between TRUST and the dependent variable CONTACT does suggest that the level of trust the investor has in the management team does have a direct impact on the investor's perceived need to be closely involved in the venture's development post investment. For investors, a basis for trust appears to be team experience, particularly in business and with new ventures generally, a line of reasoning consistent with the observed positive zero order correlations (Table 6.1) between TRUST and our relative experience predictors EIGMEXP ($r=.193$, $p<.05$) and EINVEEXP ($r=.215$, $p<.05$). Our findings provide further support behind the assertion that investor contact is directed more at addressing specific development needs as opposed to being a monitoring mechanism per se. On the basis of testing our model, **support is provided for Hypothesis 11b**.

The presence of an investor employee does not appear to mitigate the need for investors to closely interact with the venture other than in an employment capacity. Contrary to expectations, the observed beta coefficient is positive (.170) and statistically significant ($p<.05$), a basis for **rejecting Hypothesis 12b**. Two possible explanations for this finding can be advanced. On the one hand, for outside investors who are also not employees, the presence of an "investor-employee" appears to pose potential governance challenges perhaps motivated from a measure of concern that the "investor-employee" may exhibit a tendency to act in concert with the wishes of the "team" as opposed to "other investors". In reviewing all of the investments that involved syndicates, virtually no difference was found in the level of contact maintained when an investor-employee was present (14 hours per month on average) or not (13 hours per month). On the other hand, investor employees are uniquely well positioned to both identify the venture's development needs and the investor who is best suited to the task of addressing each. Reviewing the entire sample, we found that in situations where an investor-employee was present, the average level of anticipated investor contact with the venture was 20% higher than in situations where no investor was employed in some capacity. The presence of investor-employees thus appears to be an important facilitating device for managing the interaction between investors and entrepreneurs; an observation that lends further support behind the assertion that the relationship between the parties is more proactive as opposed to adversarial in nature.

Control Variables

The observed negative coefficient for the control variable DISTANCE (-.033) is not surprising as logically greater distances impose practical barriers to interaction between investor and entrepreneur. The positive coefficient between the other control variable STAGE (.053) and CONTACT is puzzling. If contact is a function of venture needs, one should reasonably expect to see a negative relationship between the variables not a positive one. One possible explanation is that later stage deals can involve a great deal of "investor grooming" for eventual exit either in terms of preparing the company for a trade sale or for flotation on a public market.

In Summary

On the basis of empirically testing the model developed to explain the anticipated level of investor contact with the venture post investment, a number of noteworthy observations are warranted. First, contrary to expectations, the anticipated level of investor involvement appears to be motivated more from a sense of addressing specific development needs of the venture as opposed to strictly being a means for protecting shareholder interests, as evidenced the negative beta coefficients reported for all the relative experience variables and, in particular, by the highly statistically significant positive beta reported for particularly small deals (INVEXTINV) where the development needs of the venture can be expected to be far more pressing in nature. Second, investors want to be involved because they feel it is an effective means for managing risk as evidenced by the positive beta for ACTIVISM as anticipated. Third, it appears that investors want to be more actively involved the greater is their stake in the outcomes, but, that the level of trust that exists between the parties appears to be to mitigate the need for close contact. Fourth, it appears to be especially important for investors to maintain more contact with the venture when they choose to invest on their own. To the extent that solo investors invest in smaller amounts and at earlier stages of development, the need for their involvement, skills and experience is more acutely felt and desired by the entrepreneur. Fifth, it appears that investor-employees are a key facilitating device for defining and initiating the involvement of investors in the venture development process.

6.4 Concluding Remarks

The two models for the dependent variables, CONTRACT and CONTACT, were empirically tested on the basis of a visual inspection of the standardised regression coefficients for individual variable constructs. Each of the predictor variables was assessed separately with our model explaining approximately 40% of the observed variance for both of our dependent variables. Zero order correlation coefficients among the predictor variables were also closely scrutinised to discern if multicollinearity was problematic.

As was discussed in section 6.1, only two of the coefficients exceeded ± .400, specifically those observed between STYLE and INVEQUITY (-.530) and between EIGMEXP and EINVEEXP (.417). We maintained that the manner in which the capital is invested (STYLE) and the size of the respondent's equity stake (INVEQUITY) were intuitively distinct and important factors to consider and that, in the first instance, both should be included in the regression model for both dependent variables, CONTRACT and CONTACT. These factors were highly significant ($p<.01$) in the CONTRACT and modestly significant ($p<.10$) in the CONTACT model specification. One possible way to assess the magnitude of the multicollinearity problem ex post is to assess the changes in observed R^2 when each of the variables is removed from the model, particularly with respect to the dependent variable CONTRACT as the statistical significance of both predictors is quite high. On the basis of this examination, the explanatory power of the model was significantly diminished when either factor was removed from the CONTRACT model as opposed to when both were included in it. If both variables were perfectly correlated, we should expect to see no loss of predictive power of the model with the exclusion of either variable.

The positive association between relative levels of general management (EIGMEXP) and new venture (EINVEEXP) experience are neither significant in the case of both CONTRACT and CONTACT model specifications nor does there appear to be any loss in predictive power when either or both of the variables are excluded. Having said this, further analysis of the partial correlation coefficients between the constituent variables which made up the composite relative experience variable (experience ratings for the entrepreneur and investor separately) revealed that, in particular for the CONTACT model specification, it was not the relative measure of experience between the parties but the absolute level of previous experience of one of the parties that mattered. The level of investor contact with the venture was negatively associated to the level of experience the entrepreneur had in the new venture setting (r=.065) and positively to the base of investor experience in business (r=.066). Variable misspecification appears to be more problematic than does multicollinearity in this instance.

As a further ex post check on the extent to which multicollinearity is problematic, variance inflation factors were computed for each of the predictor variables[2]. By regressing other predictor variables against individual predictors that are substituted in place of the dependent variable in turn, we are able to isolate potential sources of multicollinearity by observing the R^2 statistics generated as a result of running these multiple regressions. Variance inflation factors for each of the predictor variables were computed and are summarised below as Table 6.6.

[2] Multicollinearity manifests itself in the form of inflated variances of the individual regression coefficient estimators against a given dependent variable. By computing the variance of each estimator assuming that it was not collinear with any of the other predictor variables and comparing it to the observed variance for each estimator, we can gauge the extent to which collinearity is problematic. A variance inflation factor of 5 indicates that the variance of a given regression coefficient estimator is fully five times higher than what it should be if no collinearity existed (see Aczel 1993 for fuller discussion).

Table 6.6: Variance Inflation Factors:

Relative Experience Predictors:	1.377
Relative New Venture Experience (EINVEEXP)	
Relative Relevant Industry Experience (EIINDEXP)	1.177
Relative General Management (EIGMEXP)	1.417
Investor Experience Predictors:	1.260
Experience as an Investor (INVEXP)	
Active Involvement as Risk Management Tool (ACTIVISM)	1.096
Deal Attribute Predictors:	1.856
Style of Investment (STYLE)	
Size of Investment (EXTINV)	1.426
Inverse of Investment Size (INEXTINV)	1.130
Respondent Equity Stake (INVEQUITY)	1.701
Nature of Referral Source (REFERRAL)	1.184
Interpersonal Trust (TRUST)	1.264
Presence of an Investor-Employee (FULLTIME)	1.128

In interpreting variance inflation factors, the magnitude of the multicollinearity problem can be assessed by examining the extent to which reported factors systematically and greatly exceed two or three. A visual inspection of Table 6.6, reveals that while some degree of multicollinearity is present, the extent of the problem appears manageable for analytical purposes.

In terms of overall model performance, seven of twelve hypotheses were supported (five of which were significant) with respect to the model developed for explaining the nature of the CONTRACT adopted. Six of twelve hypothesised relationships (four of which were significant) were supported in our model that sought to explain the determinants of level of anticipated investor CONTACT with the venture post investment. A summary of the model's performance against both dependent variables is provided below:

	CONTRACT	CONTACT
Relative Experience Predictors:		
Relative New Venture Experience (EINVEEXP) **(+)**	**reject**	**reject**
Relative Relevant Industry Experience (EIINDEXP) **(+)**	**support ***	**reject**
Relative General Management Experience (EIGMEXP) **(+)**	**reject**	**reject**
Investor Related Predictors:		
Experience as an Investor (INVEXP) **(-)**	**reject**	**sign only**
Active Involvement as Risk Management Tool (ACTIVISM) **(+)**	**support ***	**support ***
Deal Attribute Predictors:		
Style of Investment (STYLE) **(nul)**	**reject**	**reject**
Size of Investment (EXTINV) **(+)**	**support**	**sign only**
Inverse of Investment Size (INVEXTINV) **(+)**	**support***	**support*****
Respondent Equity Stake (INVEQUITY) **(+)**	**support ****	**support +**
Nature of Referral Source (REFERRAL) **(-)**	**support ****	**reject**
Interpersonal Trust (TRUST) **(-)**	**reject**	**support ***
Presence of Investor-Employee in Venture (FULLTIME) **(-)**	**reject**	**reject**

+ (p < .10); * (p < .05); ** (p < .01); * (p < .001)**

By capturing data on actual deals, our survey also proved to be a rich source of additional information about how the informal venture capital market operates. In the chapter that follows, we will highlight a number of significant insights gained based on a deeper analysis of the survey data. We shall also revisit the issue whether the transaction cost economics and agency theory perspectives can be usefully extended into the domain of the private investor. It is to these issues that we now turn our attention.

Table 6.1: Intercorrelations Between Predictor Variables (n = 106)

		1	2	3	4	5	6	7	8	9	10	11
1	EIGMEXP											
2	EIINDEXP	.115										
3	EINVEEXP	.417***	.136									
4	INVEXP	-.153	-.209*	-.101								
5	ACTIVISM	.117	.131	.035	-.020							
6	STYLE	-.110	-.039	-.079	-.171+	-.167*						
7	EXTINV	-.001	-.145	-.136	.193*	-.063	.241*					
8	INVEXTINV	.020	-.012	.066	-.016	.093	-.250*	-.132				
9	INVEQUITY	-.035	.059	-.180+	-.072	.163+	-.530***	-.042	.102			
10	REFERRAL	-.020	-.012	.120	-.091	.044	-.004	.220*	-.049	-.056		
11	TRUST	.226*	.076	.215*	.045	.109	-.052	-.024	.007	.231*	.187*	
	FULLTIME	.193*	.017	.132	-.156	.032	.167+	.055	.070	-.147	.070	.112

Two-tailed test significance:
+ $p < .10$
* $p < .05$
** $p < .01$
*** $p < .001$

Control Variables:
Venture stage of development (STAGE)
Travel time to venture from investor's home base (DISTANCE)

Legend:

EIGMEXP = general management experience base of management relative to investors
EIINDEXP = industry experience base of management relative to investors
EINVEEXP = new venture experience base of management relative to investors
INVEXP = number of investments made in privately-held, unquoted companies
ACTIVISM = extent to which investors view active involvement as an effective means for managing risk
STYLE = form of investment participation (solo or in syndication with others)
EXTINV = total amount of capital provided by outside investors other than management
INVEXTINV = inverse of total external investment provided by outside investors
INVEXP = number of investments made in privately-held, unquoted companies
INVEQUITY = respondent's personal equity stake in the venture
REFERRAL = opportunity was referred on by a source trusted by investor and who knew the entrepreneur involved
TRUST = multidimensional construct of level of interpersonal trust between respondent and entrepreneur
FULLTIME = investor(s) employed in the venture (dummy variable)

Table 6.3: Explaining Contractual Governance
(n = 106)

Dependent Variable: CONTRACT

Predictor Variables	Standardised Betas	Hypothesis	Prediction
Relative Experience Variables:			
New Venture (EINVEEXP)	-.007	H1a	+
Relevant Industry (EIINDEXP)	.181*	H2a	+
General Management (EIGMEXP)	-.027	H3a	+
Investor Related Variables:			
Investor Experience (INVEXP)	.071	H4a	-
Active Involvement (ACTIVISM)	.184*	H5a	+
Deal Attribute Variables:			
Investment Style (STYLE)	.358**	H6a	0
Investment Size (EXTINV)	.153	H7a	+
Inverse of Investment Size (INVEXTINV)	.224*	H8a	+
Respondent Equity Stake (INVEQUITY)	.287**	H9a	+
Nature of Referral Source (REFERRAL)	-.289**	H10a	-
Interpersonal Trust (TRUST)	-.029	H11a	-
Presence of Investor-Employee (FULLTIME)	.111	H12a	-
Control Variables:			
Venture Stage of Development (STAGE)	.070		
Distance from Venture (DISTANCE)	.123		
	$R^2 = .389$		
	F = 4.145***		

One tailed test of significance:
+ p < .10
* p < .05
** p < .01
*** p < .001

Table 6.5: Explaining Anticipated Informal Contact
(n = 106)

Dependent Variable: CONTACT

Predictor Variables	Standardised Betas	Hypothesis	Prediction
Relative Experience Variables:			
New Venture (EINVEEXP)	-.074	H1b	+
Relevant Industry (EIINDEXP)	-.040	H2b	+
General Management (EIGMEXP)	-.116	H3b	+
Investor Related Variables:			
Investor Experience (INVEXP)	-.041	H4b	-
Active Involvement (ACTIVISM)	.214*	H5b	+
Deal Attribute Variables:			
Investment Style (STYLE)	-.197+	H6b	0
Investment Size (EXTINV)	.019	H7b	+
Inverse of Investment Size (INVEXTINV)	.338***	H8b	+
Respondent Equity Stake (INVEQUITY)	.189+	H9b	+
Nature of Referral Source (REFERRAL)	.041	H10b	-
Interpersonal Trust (TRUST)	-.178*	H11b	-
Presence of Investor-Employee (FULLTIME)	.170*	H12b	-
Control Variables:			
Venture Stage of Development (STAGE)	.053		
Distance from Venture (DISTANCE)	-.033		
	R^2 = .418		
	F = 4.675***		

One tailed test of significance:
+ p < .10
* p < .05
** p < .01
*** p < .001

CHAPTER 7: DISCUSSION

In the previous chapter, we provided a detailed statistical analysis of the survey data and assessed the predictive capability of our model based on empirical tests of the hypotheses outlined in Chapter 4. While our model was hypothesis driven, the findings of our study help to address a number of other issues that merit detailed discussion of their own. In this chapter, we will address each of the following questions in turn relying on the findings of our study for guidance:

1. Is the label "informal" to describe the informal venture capital market appropriate?
2. In chapter 4, we developed three two-by-two matrices (see tables 4.1 to 4.3 inclusive) as a means for classifying the relative experience of the investor and entrepreneur on each of the following dimensions: i) new venture experience, ii) relevant industry experience, and iii) general management experience. How would the respondents of this survey be classified?
3. Do active market participants operate differently?
4. How do syndicated deals differ in character from those in which the individual chooses to invest on their own?
5. How are deals that involve a venture capital fund different from those involving only private investor(s)?
6. Are transaction cost economics and agency theory useful theoretical perspectives in the domain of informal venture capital?

7.1 Is the Informal Venture Capital Market "Informal"?

By attaching the modifier "informal" to describe the market, researchers imply that investors adopt a laissez faire attitude with respect to structuring their economic relationship with the entrepreneur and that deals are made with "few strings attached" and based "on a handshake". In view of the uncertainties involved, the costs associated with undertaking extensive due diligence activities, and the legal and professional fees incurred in consummating private equity transactions, one could argue that it makes little sense for private investors to document their deals in a comprehensive fashion. In fact, a significant minority (30%) of respondents in one UK survey (Mason, Harrison and Allen 1995) reported that they did not draw up a formal investment agreement at all. The findings of our study call into question the very use of the modifier "informal" to describe the market. Our analysis supports the view that a degree of formality does exist in this market and that investors do choose to spell out in some detail their expectations of the entrepreneur and seek clarification concerning their ongoing relationship with the venture post investment.

It is particularly noteworthy that only one survey respondent reported including none of the prescribed contractual safeguards as part of the shareholder's agreement and six others incorporated two or fewer provisions in their deal with the entrepreneur. In Table 7.1, we provide a summary of all of the contractual provisions together with reported means on the three-point importance rating scale (1 = "not important"; 2 = "somewhat important; and 3 = "very important) and the proportion of investors that actually did incorporate the provision as part of their deal.

With remarkable consistency, the greater the degree of importance an investor attaches to a given contractual safeguard, the more likely that it will be included as part of the shareholder's agreement. As Landström, Manigart, Mason and Sapienza (1998) point out, one of the major uses for written contracts is to establish the "transactional parameters" of the deal. From the point of view of our respondents, there appears to be five issues that are "non-negotiable" in nature, uniformly considered as very important control mechanisms to direct the entrepreneur's behavior, and almost always included by them as a "transactional parameter" of the deal:

1. Investor veto rights over acquisition and divestiture activity (CP1);
2. Investor approval required for strategic plans and/or budgets (CP2);
3. Share option issuance restrictions (CP6);

4. Non-compete contracts required of management upon termination (CP7); and
5. Restrictions on the ability to raise additional debt and/or equity finance (CP10).

For the most part, these "non-negotiable" contractual safeguards give investors a say in material decisions that could impact the business (CP1 and CP2) or the level of their equity stake in the venture (CP6 and CP10). Non-compete contracts are, in effect, a means of maintaining a tie between the entrepreneur and the venture, thus protecting investors from what has been termed competitive opportunism (Barney, Busenitz, Fiet and Moesel 1994b).

On the other hand, there appear to be a number of contractual provisions to which investors attach relatively low importance and thus might be considered "negotiable" in nature including:

1. Forced exit provisions (CP3);
2. Investor approval required to hire/fire senior personnel (CP4);
3. The necessity of investors to countersign cheques (CP8);
4. Management equity ratchets (CP11); and
5. Specification ex ante of a mechanism to resolve future disputes in writing (CP12).

Each of these "negotiable" contractual safeguards was included in fewer than four out of ten deals. It appears that investors build in a measure of managerial discretion (CP4, CP8) and tolerate a degree of contractual ambiguity with respect to the timing of exit (CP3) and the manner in which future disputes are resolved (CP12). Interestingly, a little over one-third of the deals included management ratchet (38.7%) or dispute resolution mechanisms (36.8%). To the extent that ratchets are viewed as mechanism for "tying an entrepreneur to a set of projections", it appears that most investors prefer to establish a clear equity split up front and thereby avoiding possible future arguments about whether or not future performance does indeed exceed or fails to meet established targets and, for that matter, the basis of calculation of the performance benchmarks themselves. The importance of the working relationship between the parties is also evident in the relatively low number of deals that incorporate a specified means for resolving future disputes up front.

Our research supports the view that a "degree of formality" exists in private equity markets. There are certain key transactional parameters that investors want to clarify with the entrepreneur up front. While contractual safeguards may provide some measure of comfort for investors that the entrepreneur will act in their best interests, considering a provision as "important to include" is not the same thing as "willingness to invoke it" as a means of protecting one's interest. Strict formality implies that an investor looks primarily to the agreement to assert their rights and promote their interests.

The findings of this study, like much of the received work in the informal venture capital field, portrays a much more positive, proactive and "hands on" commitment made by investors to the development of the businesses in which they invest. On average, our respondents anticipated that investors would spend sixteen hours per month interacting with the venture, half the time being spent in face-to-face meetings of some kind and the other half equally split between time spent on the phone with the entrepreneur and time spent reviewing written reports and plans prepared for them by the entrepreneur. Our analysis supported the interpretation that investor involvement, rather than being a means for defending one's interests, appears to be motivated more in response to specific venture development needs. This conclusion is also backed up by the observation that almost two-thirds of investors appear to prefer relying on the relationship with the entrepreneur to resolve future disputes as opposed to specifying a mechanism ex ante on how to deal with them. Our sense from speaking with respondents is that the primary use of contractual safeguards is not to look to them as protection mechanisms per se but rather as a means for clarifying mutual behavioral expectations of both parties (Landström, Manigart, Mason and Sapienza 1998).

7.2 Relative Experience Across the Investor-Entrepreneur Interface: Classifying Respondents

In Chapter 4, we maintained that the potential for opportunistic behavior to occur across the investor-entrepreneur interface may be particularly problematic in situations where either party to the exchange has a greater base of experience to draw upon than the other. From the perspective of investors, we argued that the most challenging situation faced (and hence the greatest agency risk) is when the management team possesses a greater base of experience relative to them. We portrayed relative experience between the parties in the form of two-by-two matrices on each of the following dimensions: i) new venture experience, ii) relevant industry experience, and iii) general management or business experience. Where do the findings of this study suggest we position our respondents within these matrices? We shall deal with each of the respective experience variables in turn and for ease of reference have reproduced tables 4.1, 4.2 and 4.3 here as tables 7.2, 7.3 and 7.4 respectively.

Table 7.2: New Venture Experience Across the Investor-Entrepreneur Interface

Previous New Venture Experience	**Investor Low**	**Investor High**
Entrepreneur Low	Ignorance	Engagement
Entrepreneur High	Protection	Parsimony

Our study confirms the findings of previous research supporting the claim that private investors are remarkably entrepreneurial individuals in their own right (Coveney and Moore 1998; van Osnabrugge 1998b; 3i Group 1994). Almost three-quarters of our respondents had started a business of their own and, of those that had, almost 40% have started two or more. It should not be surprising, therefore, to note that their average reported base of investor experience in the new venture setting (3.85) (rated on a five-point scale ranging from 1 = "no previous experience" to 5 = "extensive previous experience" and anchored by 3

= "some experience") significantly exceeded that reported for management (2.58). In such circumstances, our typical respondent should be classified as employing an "**engagement**" approach. In effect, the investor's intimate knowledge of how to build a new business and the pitfalls associated with the process along the way can help them to detect value detracting behavior on the part of the entrepreneur and provide them with a clearer sense of when and how their skills and experience are best put to use. Based on the observed negative beta coefficient between EINVEEXP and CONTACT (-.074), "engagement" appears to be a function of venture need; the more experience investors have relative to entrepreneurs in the new venture setting, the more involved investors want to be in the venture's development going forward.

Table 7.3: Relevant Industry Experience Across Investor-Entrepreneur Interface

Previous Relevant Industry Experience	Investor Low	Investor High
Entrepreneur Low	Shot in the Dark	Back Seat Driver
Entrepreneur High	Protection	Selective Intervention

With respect to relevant industry experience, investors reported on this dimension that management did indeed, on average, bring more experience to bear (4.23) than they did (3.13). In such circumstances, the potential for entrepreneurs to engage in opportunistic behavior may be problematic and we would expect to see investors build in protective measures, either into the formal contract or through closely monitoring developments post investment. Our study did find that investors built in relatively more contractual safeguards into the deal up front in situations where the balance of experience favored the management team supporting a classification of "**protection**". The observed beta coefficient between the relative experience variable (EIINDEXP) and the dependent variable CONTRACT was positive (.181) and statistically significant ($p<.05$). The observed negative beta coefficient between

EIINDEXP and CONTACT (-.040) indicates that investor input appears to be a function of venture need, an interpretation that would support a "**selective intervention**" classification.

Table 7.4: General Management Experience Across Investor-Entrepreneur Interface

Previous General Management Experience	Investor Low	Investor High
Entrepreneur Low	Blind Leading Blind	Mentor Partner
Entrepreneur High	Silent Partner	Business Partner

Previous research has also demonstrated that one of the key ingredients private investors also bring to bear on the venture development process is extensive general management experience (3i Group 1994). The findings of our study lend further support to this claim; the reported experience rating for investors was 4.50 as compared to 3.54 for the management team. In such circumstances, investors are well positioned not only to provide practical and useful business advice to entrepreneurs as required but should be able to detect opportunistic behavior on the part of management in a timely manner. It appears that the relationship between the parties can best be characterised as a partnership. Whether viewed as a mentor or business partnership appears to be a function of the relative need for the investor's input as evidenced by the negative beta coefficient between EIGMEXP and CONTACT (-.116). To the extent that the general management experience in the management team is low, investors can best be viewed as **mentor partners**. In situations where the entrepreneur is an experienced business person, the investor is best considered to be a **business partner**.

7.3 Do Experienced Investors Operate Differently?

By design, we sought out the views of a broad spectrum of active private investors in the UK by tapping into a variety of different sources of potential respondents. At an aggregate level, we argued that very active market participants would adopt a more parsimonious approach to documenting their contractual deals with the entrepreneur than their less experienced colleagues. We also maintained that active market participants might also face capacity constraints in terms of their ability to be intensively involved in the development of any one venture in view of the larger number of investments they must manage overall. Based on the statistical analysis of the data discussed in the previous chapter, we found that active investors incorporate relatively more contractual safeguards up front but expect to interact relatively less post investment than their less active colleagues.

To gain additional insights, we partitioned the sample into three distinct groups based on the number of investments completed to date: i) less than 4 investments, ii) 4-9 investments, and iii) 10 or more investments. All three groups are profiled in Table 7.5 with respect to a number of variables below.

Table 7.5: Sample and Sub-Group Profiles

Attribute	< 4 investments (n = 37)	4-9 investments (n = 44)	10+ investments (n = 25)
# Contractual Provisions Included	6.84	6.66	7.00
Anticipated Contact (hrs/month)	15.3	18.8	15.6
Average External Investment	£178,000	£265,000	£638,000
% Early Stage Investments	78%	75%	68%
% Syndicated Deals	73%	71%	60%
% Investor-Employee Present	43%	39%	32%

A number of striking observations can be made on the basis of this arguably arbitrary grouping scheme. First, in terms of their approach to structuring and managing their relationship with the entrepreneur either ex ante (CONTRACT) or ex post (CONTACT), all three groups are broadly similar. Second, it appears that as investors become more active market participants, they are involved in much bigger deals. Third, despite the tendency to focus on later stage investments as investors complete more deals, there is a remarkable conviction displayed for investing in early stage proposals throughout. Fourth, it appears that confidence to underwrite deals on their own increases as the number of investments completed increases. Very active market participants may have also acquired a reputation among intermediaries, such as banks or accounting firms, as a "deal-maker" and hence be shown potential opportunities that have not been widely circulated (Kelly and Hay 1998). Fifth, the practical time constraints faced by those individuals with large portfolios manifests itself in the form of lower proportions of deals that involve an investor assuming an employment position in the venture.

Further insights into the specific tact taken by investors with respect to the importance placed upon and inclusion of contractual safeguards is also provided in Table 7.6 below. For ease of comparison, we partitioned the sample into three subgroups along the same lines adopted in the previous table.

Table 7.6: Contractual Governance: Sub-Group Profiles

% rated "very important" (% deals where included)	Less than 4 Investments	4 to 9 investments	More than 10 investments
Investor veto rights over acquisitions and/or divestitures	68 (81)	61 (75)	60 (80)
Investor approval required for strategic plans and/or budgets	73 (81)	61 (82)	48 (68)
Management can be forced to seek an exit by investors	19 (22)	30 (36)	24 (36)
Investor approval required to hire and/or fire senior personnel	38 (49)	11 (31)	12 (40)
Management compensation levels must be approved by investors	49 (76)	32 (52)	36 (56)
Share options may not be issued without investor approval	60 (70)	48 (73)	64 (92)
Non-compete contracts required of management upon termination	46 (70)	50 (75)	52 (80)
Investor veto rights over capital expenditure plans	46 (65)	34 (50)	32 (48)
Investor must countersign cheques above a certain amount	14 (22)	21 (30)	8 (8)
Restrictions on ability to raise additional debt or equity finance	81 (87)	75 (84)	84 (100)
Management equity ratchet provisions are included	19 (24)	27 (43)	36 (52)
Specific dispute resolution mechanism is agreed in writing	38 (38)	21 (34)	28 (40)

A number of noteworthy observations can be made on the basis of the data presented in Table 7.6. In general, it appears that less experienced investors, those individuals who have completed less than four investment to date, place relatively greater importance on the need to include a broader array of contractual safeguards to protect and promote their interests as shareholders. Having said this, there appears to be widespread similarity across sub-groups on four seemingly non-negotiable provisions that are included in the vast majority of deals: i) veto rights over acquisitions and/or divestitures; ii) approval for strategic plans and/or budgets; iii) non-compete contracts; and iv) restrictions on the ability to raise additional equity or debt finance without investor approval. However, specific provisions that can impact the level of investor equity stake (share option issuance and ratchet provisions) and the timing of exit (forced exit provisions) feature more prominently in deals that involve more experienced investors. It would appear that with experience, investors become more focussed on elements that can impact their potential financial return, namely their stake in the outcome and the timing of such value realization.

7.4 How Does the Approach of A Syndicate of Private Investors Differ From That Adopted By Solo Investors?

We were also able to discern distinct differences in approach by partitioning the sample on the basis of how the capital was invested into the venture. Our sample captured data on 33 investments that involved a solo investor, 61 that involved a syndicate of private investors with the remainder (12) being underwritten in part by a venture capital fund. We shall defer a detailed examination of the deals involving a venture capitalist until section 7.5 and focus our attention now on the ventures that raised money from private individual(s) exclusively.

The investment activity of solo investors was relatively more focussed on early stage proposals (80% of total) than was the case for syndicates (70%). Moreover, solo investors anticipated spending 50% more time (22 hours/month on average) than syndicates interacting with the venture and, in particular through face-to-face meetings. In terms of size of investment round, entrepreneurs were able to raise more than two times as much capital from syndicates (£350,000 on average) as was the case with solo investors (£140,000). However, it would also appear that syndicates require greater capital contribution from the entrepreneur (£90,000 on average) than is required by solo investors (£50,000).

In terms of how investor(s) choose to structure their contractual deal with the entrepreneur and the importance placed on specific safeguards to promote and protect their interests as shareholders, Table 7.7 provides a comparison between solo and syndicated investments in our sample.

Table 7.7: Contractual Governance: Sub-Group Profiles

% rated "very important" (% deals where included)	**Solo Investor** (n=33)	**Syndicates** (n=61)
Investor veto rights over acquisitions and/or divestitures	49 (67)	71 (84)
Investor approval required for strategic plans and/or budgets	58 (76)	61 (77)
Management can be forced to seek an exit by investors	24 (27)	26 (34)
Investor approval required to hire and/or fire senior personnel	18 (36)	21 (39)
Management compensation levels must be approved by investors	30 (49)	48 (64)
Share options may not be issued without investor approval	46 (79)	57 (75)
Non-compete contracts required of management upon termination	36 (70)	61 (75)
Investor veto rights over capital expenditure plans	30 (46)	43 (57)
Investor must countersign cheques above a certain amount	12 (18)	18 (26)
Restrictions on ability to raise additional debt or equity finance	73 (88)	80 (89)
Management equity ratchet provisions are included	33 (49)	25 (34)
Specific dispute resolution mechanism is agreed in writing	21 (36)	28 (38)

From the data presented in Table 7.7, a number of observations are worthy of note. First, from a visual inspection of the proportions of respondents who considered it "very important" to include a given contractual safeguard, it appears that syndicates, in general, attribute relatively more importance to a diverse number of provisions to protect and promote their interests as shareholders than is the case when an individual invests on their own. Moreover, syndicates appear to be more likely to call for: i) veto rights over acquisition and divestiture activity; ii) more say over the level of management compensation; and iii) closer scrutiny of capital expenditure plans presented to them. Our data supports the interpretation advanced by Landström, Manigart, Mason and Sapienza (1998) that syndicated investments imply a greater degree of contractual complexity as each participant in the syndicate seeks to incorporate their own view on how best to structure the relationship into the contractual framework that is eventually adopted. On the face of it, the greater reliance solo investors place on including ratchet provisions may compensate for their inability to establish an appropriate valuation on the business ex ante as well as being a mechanism for "bonding" entrepreneurs to the financial projections they present to investors. Having said this, both solo investors and syndicates tolerate a degree of contractual ambiguity up front, in more than 60% of the investments reviewed no formal mechanism for resolving future disputes was established between the parties in writing ex ante.

Through our research design we were also able to obtain data on a small number (12) of investments that involved the participation of a venture capital fund. The interface between the informal and formal venture capital markets is an interesting, but largely unexplored, area of research study worthy of detailed discussion in its own right. Are there any distinguishing characteristics of the deals that involved a venture capitalist? It is to this issue that we now turn our attention.

7.5 Is the Approach Different When Venture Capital Funds are Involved?

Freear, Sohl and Wetzel (1990) were among the first to recognize a perceived degree of complementarity between the formal and informal venture capital markets inasmuch as private investors typically invest in smaller amounts and at earlier stages of development than do venture capitalists. The underlying logic of their observation is that private investors are involved early on to shape the business into an "investment ready" proposition for venture capital funds later on. In short, the implied roles of the informal and venture capital markets are viewed as quite distinct, one following on from the other.

In another sense, it also is possible for venture capitalists and private investors to work together from the start. Some venture capital funds, notably 3i in the UK, have actively sought out and co-invested alongside private investors as a means for achieving portfolio diversification and, more importantly, as a means for altering the economics of venture capital finance in favourable ways. Murray (1994) noted the apparent diseconomies faced by venture capital fund managers in trying to build and manage a portfolio of small early stage investments which implies both costly due diligence ex ante and intensive investor involvement ex post. By investing alongside an individual who may have specialized knowledge of benefit in assessing the risks of the deal and who, by virtue of placing their own funds at risk, are motivated to be actively involved in the venture's development, the venture capital fund benefits from both lower due diligence costs and a reduced need to be involved in a "hands on" manner in the venture development process.

Irrespective of whether the venture capital fund invests at the same time with private investors or chooses to invest at some point in the future after them, a number of interesting issues remain largely unresolved to date. Do venture capitalists and private investors operate differently with respect to their approach to structuring their relationship with the entrepreneur and managing risk post investment? Are the two styles compatible? What implications does this have for entrepreneurs raising capital?

By virtue of the research design employed in this study, we are able to draw some comparisons between deals that involved strictly private investors and a small number of others that involved syndication with a venture capital fund. A profile of the investments made by each group is summarised below:

Table 7.8: Profiling the Differences When Venture Capital Funds Are Involved

Attribute:	No Venture Capital Fund Involvement (n = 94)	Venture Capital Fund Involvement (n = 12)
Mean Total Investment Raised Externally	£275,000	£705,000
Mean Management Equity Stake Retained Post Investment	54%	45%
Proportion of Investments Made in Seed and Early Stage Ventures	74%	50%
Proportion of Deals Where An Investor was Employed	63%	50%
Anticipated Level of Investor Contact Post Investment	17 hours/month	12 hours/month

Based on this comparative profile, a number of observations can be made. First, it appears that one of the benefits of involving a venture capital fund is that private investors can participate in much larger deals. Second, both groups display a conviction to investing in early stage businesses. For venture capital fund managers in particular, investing alongside private investors may be an effective means to achieve not only a useful business end, diversification, but, importantly, change the widely held perception that there is no "venture" in venture capital in Europe (Murray 1992). Third, the interpretation that private investors can be viewed as actively engaged risk managers is borne out by the observed similarity in the proportion of deals financed by both groups where an investor is employed in the venture in some capacity. Both groups also anticipate spending a few hours per week interacting with the venture post investment. The need for intensive involvement is probably lower in the case of deals where a venture capital fund is involved as they are, as often as not, backing a later stage proposal with fewer development needs.

Are there fundamental differences in how the two groups approach the task of structuring the relationship with the entrepreneur? We carefully analyzed the responses of each group with respect to the degree of importance attached to including specific contractual safeguards up front and the proportion of investments that incorporated each. "Importance" was assessed on the basis of a three-point scale ("not important" = 1; "somewhat important" = 2; and "very important" = 3). A summary of the data is provided in Table 7.9 below:

Table 7.9: The Nature of the Contractual Deal

Contractual Safeguards	Importance Ratings		Proportion of Deals Included	
	No VC Fund Was Involved	VC Fund Was Involved	No VC Fund Was Involved	VC Fund Was Involved
Investor veto rights over acquisitions and/or divestitures	2.54	2.67	78%	83%
Investor approval required for strategic plans and/or budgets	2.49	2.83	77%	92%
Management can be forced to seek an exit if required to do so by investors	1.86	1.58	32%	25%
Investor approval required to hire and/or fire senior personnel	1.87	2.08	38%	50%
The level of management compensation must be approved by investors	2.18	2.08	59%	83%
Share options may not be issued without the approval of investors	2.29	2.75	77%	75%
Non-compete contracts required of management upon termination	2.36	2.08	73%	83%
Investor veto rights over capital expenditure plans	2.13	2.08	75%	83%
Investor must countersign cheques above a certain amount	1.51	1.33	23%	8%
Restrictions on the ability to raise additional debt or equity finance	2.70	2.92	88%	92%
Management equity ratchet provisions are included as part of the deal	1.90	1.75	39%	33%
A specific dispute resolution mechanism is agreed in writing	1.98	2.25	37%	33%

From a visual inspection of the data presented in Table 7.9, a number of observations are noteworthy. First, when venture capital funds are involved, more importance is attached to big picture issues such as the nature of the business and the underlying strategy, plans and budgets developed by the team than is the case for private investors. Second, greater concern is expressed about issues that can affect the relative equity stakes of investors (share option schemes, financing restrictions) when venture capital funds are involved. Third, it appears that the nature of the contractual deal struck with the entrepreneur is "tighter" when a venture capital fund is part of the syndicate. By "tighter", we mean that a higher proportion of deals that involved a venture capital fund included more contractual safeguards, particularly as relates: i) approval for plans and/or budgets; ii) hiring/firing decisions; iii) management compensation limits; and iv) non-compete contracts. With greater funds at risk and institutional fund providers to answer to, it is not surprising to see greater attention to contractual detail when a venture capital fund is participating.

On the basis of our small sample, it appears that there are notable differences in approach when a venture capital fund participates as part of a syndicate. The presence of private investors appears to alter classic venture capital economics for fund managers, however, the nature of the deal struck with the entrepreneur is visibly more formal than is the case when only private investors are involved. What the implications of this difference are will be addressed in the concluding chapter that follows.

7.6 Are Transaction Cost Economics and Agency Theory Useful Theoretical Lenses?

In Chapter 3, we highlighted the complementarity of the transaction cost economics and agency theoretical perspectives in trying to understand the choices parties to an economic exchange make with respect to structuring their relationship with one another. The central concern of both perspectives is on developing a structure that promotes the economic interests of all parties to the transaction, curbs the potential for opportunistic behavior to occur, and allows the necessary degree of flexibility for all parties to adapt to changed and unforeseen circumstances.

A number of reasons were advanced that potentially call in to question the utility of extending these theoretical perspectives into the domain of informal venture capital. In particular, we expressed concerns about the nature of the underlying assumptions upon which both these perspectives are based, namely that: i) parties to an exchange will display a tendency to pursue their own self-interest to the detriment of the other party, thus leaving little room for trust to prevail between them; and ii) that individuals are motivated solely by economic considerations, namely maximizing their own wealth. Moreover, we argued that both perspectives also appear to be better suited to addressing issues related to larger established publicly-listed companies that are characterized by widely diffused shareholding structures and generally liquid markets for equity shares. These limitations notwithstanding, we considered it appropriate to put these theoretical perspectives "to the test" in a very different context, the domain of the private investor, an environment that is characterized by relatively concentrated shareholding structures in highly illiquid equity instruments. Were these theoretical perspectives useful? Based on the findings of our study, we shall address this issue for each perspective in turn.

Transaction Cost Economics

Confirming Potential Utility

The focus of the transaction cost economics perspective on contractual detail and highly legalistic mechanisms for structuring relationships does appear to hold some degree of relevance in the domain of informal venture capital. Of particular interest to advocates of this theoretical perspective are the findings of this study with respect to explaining observed variations in the dependent variable CONTRACT. On the basis of this study, it appears that:

1. Contracts are an important mechanism to establish the transactional parameters with the founding team up front (Landström, Manigart, Mason and Sapienza 1998).
2. The potential for opportunistic behavior to occur is most acutely felt in an area where investors considered that they had relatively less personal experience to bring to bear than the management team, namely relevant industry experience.
3. Deals that involve a syndicate of investors implies difficulties in clarifying the rights of all the parties to the transaction thus resulting in more comprehensive contractual arrangements negotiated up front.

4. The degree of contractual specificity increases as a direct function of the respondent's personal equity stake in the outcome.

5. If an investor intends to be an active participant in the venture development process, the transactional parameters of the relationship need to be specified quite explicitly up front.

Exposing Potential Limitations

Our study did, however, provide some measure of affirmation in our belief that extending the transaction cost perspective into the domain of informal venture capital may not be entirely appropriate. Based on our findings, three major issues stand out:

1. Private equity transactions are infused with a high degree of interpersonal trust between the parties from the outset. Interpersonal trust does impact the decisions investors make as to how to structure their economic relationship with the entrepreneur in two ways. First, aside from acting as an initial screen, deal referrers whose opinion and judgement is trusted by investors and who are knowledgeable about the proponents do significantly influence the form of the contractual deal struck up front with the entrepreneur. Fewer contractual safeguards were included in situations where a deal was referred on by such sources. Second, a direct relationship between TRUST and anticipated level of CONTACT was observed; in short, high levels of trust mitigate the perceived need to maintain close contact with the venture post investment. Our study supports the view that the integrity of the people is a central concern of private investors (Fiet 1991) and that the source of referrals matters (Freear, Sohl and Wetzel 1997). To ignore the important moderating influence that interpersonal trust between the parties can have on the structure of the relationship between investors and entrepreneurs appears to be a major omission of the transaction cost perspective. In some respects, our findings support the assertion of Aldrich and Zimmer (1986) that as a theoretical lens, transaction cost economics is "under-socialized".

2. While strict advocates of the transaction cost perspective would call for the parties to agree on a manner in which to resolve future disputes ex ante, our study supports the view that a degree of contractual ambiguity appears to be built in from the start. In almost two-thirds of the deals reviewed, investors chose not to include a specific dispute resolution mechanism in writing up front. This is somewhat surprising in view of the fact that respondents considered such a provision "somewhat important" to include as part of the contractual deal struck ex ante.

3. While it was beyond the scope of this study to explore whether investors actually rely on contracts to protect and assert their interests, formal contracts appear to be but one way investors direct the behavior of management in desired ways. Informal interaction with the venture and active work on the board of directors are also considered to be important means by which investors can influence the decisions of management. Our study thus lends some support to the observation advanced by Landström, Manigart, Mason and Sapienza (1998) that contracts may form an initial blueprint for how the relationship is

structured, but that the personal relationship that develops between the parties is viewed as a key mechanism for adapting to unforeseen circumstances going forward.

Agency Theory Perspective

Confirming Potential Utility

With its emphasis on the design of the incentive system to solve potential problems with respect to how the relationship between investor and entrepreneur is structured, the agency theory perspective holds an intuitive appeal for dealing with governance challenges in entrepreneurial ventures. Based on the findings of our study, a number of observations can be advanced in support of the claim that agency theory is a potentially useful theoretical lens in the domain of informal venture capital:

1. We found strong support for a central tenet of agency theory, namely that the relative equity stakes of the parties to the exchange matter. Positive and significant beta coefficients were reported between level of respondent equity stake (INVEQUITY) and both dependent variables, CONTRACT (.224, $p<.05$) and CONTACT (.189, $p<.10$).

2. In addition, it appears that investors place a great deal of importance to, and often include, specific contractual safeguards that protect them from actions that, could impact their relative equity stake in the venture over time. As evidenced in Table 7.1, among the most important and often included contractual safeguards are those that can have a direct bearing on, and impact the level of, the investor's equity stake in the venture: i) restrictions on raising additional finance; ii) veto rights over acquisitions or divestitures; and iii) restrictions on issuing share options. Our review of the data suggested that almost 60% of the contractual deals incorporated all three of these provisions and almost 90% incorporated at least two of them.

3. The findings of our study also confirmed, to some extent, that the degree of information asymmetry that exists between the parties matters. We maintained that the level of agency risk faced by investors is a direct function of the degree of information asymmetry present between themselves and the entrepreneur or founding team. This was particularly evident with respect to the base of relevant industry experience that tended to be skewed in favor of the management team. The degree of information asymmetry between the parties was also more evident in situations where an individual invested on their own as opposed to participating in a syndicate consistent with our line of reasoning that the experience base of a group of investors should exceed that for an individual investing on their own.

Exposing Potential Limitations

As was the case with the transaction cost economics perspective, our study did highlight a significant issue that calls into question the potential usefulness of extending agency theory into the domain of informal venture capital. The relationship between investor(s) and entrepreneurs is more positive in character than agency theory would suggest (Landström 1992) for a number of reasons:

1. For similar reasons as advanced with respect to the transaction cost perspective, the economic relationship between investor and entrepreneur appears to be infused with high levels of interpersonal trust from the outset. It appears that investors operate from a "presumption of trust" and not a "presumption of distrust" as agency theory would suggest.

2. Further analysis of the data revealed that rather than being a means of defending their interests, the level of anticipated investor contact with the venture post investment seems to motivated by the specific development needs of the venture as evidenced by the consistently negative beta coefficients reported between the three relative experience variables and the dependent variable CONTACT (see Table 6.3).

3. The "venture need" interpretation is also supported by the observation that investors anticipate maintaining higher levels of interaction with ventures in which they have invested relatively small sums of capital at risk. To the extent that smaller equity infusions are sought at earlier stages of the venture's development, the need for close investor involvement is probably more acutely felt and wanted by the entrepreneur.

4. Our study lends strong support for the assertion that investors consider active involvement in the venture development process to be an effective means for managing risk. They appear to be motivated from the start to bring their skills and experience to bear on situations where they can make value added contributions to the value creation process (Harrison and Mason 1992c). In this sense, investor activism appears to be a means of promoting shareholder's interests and in doing so, protecting them as well. The implied (and negative) emphasis placed on defending and protecting one's interest as advocated by agency theory appears to be misplaced in the context of informal venture capital.

On balance, are the transaction cost economics and agency theory perspectives useful lenses or not in the domain of informal venture capital? In one sense, both perspectives lend much needed structure to a field of study whose theoretical underpinnings are still in the very early stages of development. In another sense, the domain of informal venture capital has highlighted in bold relief some of the significant shortcomings of the underlying assumptions upon which both perspectives are based. The world of the private investor is fundamentally different from that of publicly listed firms although there appears to growing awareness that the intensity and breadth of investor involvement with ventures may hold many useful insights for shareholders of larger publicly-traded firms (Bhide 1994). For reasons that we will elaborate upon in the chapter that follows, we will conclude that: i) the transaction cost economics perspective is of limited utility in the domain of informal venture capital; ii) agency theory, and in particular, the incomplete contracts approach (van Osnabrugge 1999), appears to be better suited for the task of developing our understanding of why the relationship between entrepreneur and private investor(s) is structured the way it is; recognizing, however that; iii) both parties appear to seek out cooperative as opposed to competitive solutions (Cable and Shane 1997) which implies integrating more socialized theoretical perspectives such as procedural justice (Sapienza and Koorsgaard 1996).

7.7 Conclusion

Building on the statistical analysis presented in the previous chapter, our data set proved to be a rich source of additional insights into a number of important issues in the entrepreneurial finance field. First, there appears to be a degree of formality that exists in the informal venture capital market. Second, the relationship between the parties seems to be much more positive in character than either transaction cost economics or agency theory would suggest. Investor contact appears to be motivated by venture need as opposed to being a means of checking entrepreneurial behavior and that being active participants in the process is a particularly effective means of managing risk. Third, the most active segment of our respondents, those individuals who have completed ten or more deals to date, display a tendency to participate in much larger, later stage proposals and appear to have the discretionary funds available and confidence in their abilities to invest on their own as well. Typically, this most active element of the sample places less importance on a broad array of contractual safeguards but are most concerned about, and control for, matters that can impact the level of their equity stake in the venture and the timing of exit. Fourth, participating as part of a syndicate of private investors affords the opportunity to participate in larger deals often at a later stage in the venture's development. It also appears that syndicates are perhaps more efficient means of interacting with the venture post investment. Although syndicates typically spend 50% less time interacting with the venture, the diversity of skills and experience available in the investor group may facilitate the process of involving the investor best suited to the task expediently. Having said this, the nature of the contractual deal struck with a syndicate also appears to be more complex and comprehensive in nature than is the case when an individual is investing on their own. Fifth, the presence of a venture capital fund in a syndicate does imply an added measure of contractual formality than is the case when only private individuals are involved. Accountable as they are to their institutional fund providers, contractual specificity is perhaps one concrete way venture capital fund managers signal decision-making competence to their own investors (Cable and Shane 1997). Interestingly, it appears that investing alongside private investors may be an important means by which fund managers can alter the economics of classic venture capital investing in favourable ways. A large proportion of the deals involving a venture capitalist were in the early stages of development (50%) and/or involved the private investor assuming an employment position in the venture (50%) itself. It would appear that the complementary resource of greatest importance between the formal and informal venture capital markets is not the capital per se but rather the time to be able to interact with the venture and make value added contributions to its development post investment. It appears that private investors are well suited to assume this role. Finally, we concluded that the relationship between the investor(s) and entrepreneur was infused with a higher degree of trust and was more positive in character than strict adherents of the transaction cost economics or agency theory perspectives would suggest. As will be discussed at greater length in the concluding chapter that follows, the most promising theoretical frameworks for informal venture capital should start from the notion that contracts are a necessarily incomplete and blunt governance mechanism. Moreover, the relationship that develops between the parties appears to be the key basis towards finding a cooperative solution to the puzzle of how to structure their economic relationship with one another (Cable and Shane 1997). On the basis of this study, what have we learned and where are the future paths for research enquiry? It is to this question that we now turn in the concluding chapter that follows.

Table 7.1: Contractual Governance: A Summary

CONTRACTUAL PROVISION	AVERAGE IMPORTANCE RATING (Rank)	% OF DEALS WHICH INCLUDED PROVISION (Rank)
Investor veto rights over acquisitions and/or divestitures (CP1)	2.56 (2)	78.3% (T2)
Investor approval required for strategic plans and/or budgets (CP2)	2.53 (3)	78.3% (T2)
Management can be forced to seek an exit if required to do so by investors (CP3)	1.83 (11)	31.1% (11)
Investor approval required to hire and/or fire senior personnel (CP4)	1.90 (9)	39.6% (8)
The level of management compensation must be approved by investors (CP5)	2.17 (6)	61.3% (6)
Share options may not be issued without the approval of investors (CP6)	2.34 (4)	76.4% (4)
Non-compete contracts required of management upon termination (CP7)	2.33 (5)	74.5% (5)
Investor veto rights over capital expenditure plans (CP8)	2.12 (7)	54.7% (7)
Investor(s) must countersign cheques above a certain amount (CP9)	1.49 (12)	21.7% (12)
Restrictions on the ability to raise additional debt or equity finance (CP10)	2.73 (1)	88.7% (1)
Management equity ratchet provisions are included as part of the deal (CP11)	1.87 (10)	38.7% (9)
A specific dispute resolution mechanism is agreed in writing (CP12)	2.01 (8)	36.8% (10)

CHAPTER 8: CONCLUSION

8.0 Introduction

In this study, we sought to better understand the impact various contextual factors have on the choices private investors make as to how to structure their relationship with the entrepreneur. Too often, businesses with growth potential consciously choose to forego the stimulative benefits of raising external capital in the fear that loss of equity control necessarily implies loss of managerial control. In undertaking this study, we wanted to be able to provide salient deal specific information in the belief that "more informed consumers" (entrepreneurs) will "make the purchase" (raise equity). Equally, numerous studies have also highlighted that a significant proportion of investors has yet to complete their first deal, so called virgin investors. By tapping into the experience base of active investors, we also are motivated in the belief that "more informed producers" (investors) will "agree to sell" (invest equity).

In an effort to instill a measure of theoretical discipline into the emerging field of study we know as informal venture capital, of necessity we needed to look outside the field for guidance. We developed a model relying on two complementary theoretical perspectives borrowed from the field of industrial economics, transaction cost economics and agency theory. As mechanisms for developing "early stage organizing frameworks" to better understand the informal venture capital phenomenon, both perspectives were useful. Having said this, the domain of the private investor who takes equity stakes in businesses that are illiquid in nature and run by individuals whose skills are virtually irreplaceable, has highlighted in bold relief some of the limits of extendibility of both the transaction cost economics and agency theory perspectives. Our reservations notwithstanding, in view of the nascent state of development of the field, we thought it appropriate to put these theoretical perspectives to the test empirically.

From the outset, the objectives of this study were to better understand not only how the relationship between investor(s) and entrepreneur is structured but, more importantly, to identify the contextual factors that can have a significant bearing on these decisions. In so doing, we wanted to be able to draw a sharper distinction between the concepts of "managerial" and "equity" control. By including the modifier "informal" to describe the phenomenon, a perception is also created that private equity transactions by their very nature are loosely structured. In this study, we also sought to gain insights into whether this "perception" manifests itself in "reality". Moreover, as was discussed in Chapter 3, there are reasons to believe that "market" for informal venture capital differs significantly in character from that which both transaction cost economists and agency theorists are familiar with and upon which much of the received research has been based. Private investors face both highly inefficient markets for entrepreneurial talent to replace ineffective management and often lack the mechanisms available to shareholders in publicly-traded firms to expediently sell their equity stakes as an expression of displeasure with the actions of management. Having said this, one of the objectives of this study was to assess whether either of these perspectives could be usefully extended into the domain of informal venture capital. From the outset, we also believed that private equity transactions are infused with a high degree of interpersonal trust between the parties, a factor that is largely ignored and unaccounted for in most of received research relying on either transaction cost economics or agency theory. In this study, we also sought to gain insights into the influence that trust between the parties can have on the decisions of how to structure their economic relationship.

In this chapter, we will summarize the key findings of this study, identify fruitful areas for future research inquiry, and draw out some of the implications for private investors, venture capitalists, entrepreneurs and policy-makers. As with any study in the field of informal venture capital, the usual caveat emptor proviso applies. In the absence of any objective information on the characteristics of the overall population, it simply is not possible to assess the representativeness of any sample including the one relied upon in this study. As long as the informal venture capital market maintains its largely invisible character, we are only able to advance "informed judgements" as opposed to "firm conclusions". On the basis of this study, what "informed judgements" can we make? It is to this issue we now turn.

8.1 Conclusions

The Contractual Agreement: A Basis for Defining Co-operation

While there is readily accessible and widely distributed information available to investors and entrepreneurs alike on specific terms and conditions that *can be* negotiated and incorporated into shareholder agreements, this study provided insights into what contractual safeguards are *considered important* and *actually included* in specific deals. Generally speaking, the respondents we surveyed intended from the outset to be active participants in the venture development process and considered close interaction with the management team to be a particularly effective means of managing risk. By virtue of this, contracts appear to be one means by which investors specify the "rules of the game" and clarify the respective roles and responsibilities of all parties to the transaction at the outset. Establishing this guiding framework for ongoing co-operation seems to be widely utilized as, *with only one exception*, all of the investments we reviewed did employ some form of written contract between the investor and the entrepreneur.

Based on our analysis, we were able to identify a number of "transactional parameters" that featured in a large proportion of deals reviewed and were uniformly considered as important safeguards by investors across the sample. In three-quarters or more of the investments we reviewed, investors attached a reasonable measure of importance to, and included contractual safeguards in specific areas that could affect the underlying nature of the business and/or impact the shareholding structure in undesirable ways to them including:

- Restrictions on management's ability to raise additional debt or equity finance without prior investor consent
- Investor veto rights over acquisition and divestiture activity
- Investor approval required for strategic plans and/or budgets
- Restrictions on management's ability to issue share options without investor consent
- Non-compete contracts required of management upon termination

We also identified a number of other issues where it appears the entrepreneur is afforded some measure of discretion by investors including:

- The ability to write cheques on company bank accounts
- The manner and timing of eventual exit (forced exit provisions)
- Decisions related to hiring or firing senior personnel

Moreover, a degree of contractual ambiguity appears to be tolerated by investors as in a little less than two-thirds of the investments reviewed, no formal mechanism for resolving future disputes between the parties was incorporated into the shareholder's agreement up front. Aside from the practical difficulties of being able to specify all of the possible contingencies that may arise, it would appear that investors are looking to the working relationship that will develop between the parties as a basis for flexibly dealing with difficulties as they are encountered. The findings of this study support the conclusions advanced by van Osnabrugge (1999) and Landström, Manigart, Mason and Sapienza (1998) that contracts are necessarily incomplete by their very nature and that the relationship between the parties is an important element to provide the flexibility to adapt to change as circumstances warrant.

Drivers of Contractual Specificity

Establishing a comprehensive contractual arrangement appears to be especially important in situations where: i) the founding team brings more relevant industry experience to the table than do investors; ii) the investment is made by a group as opposed to a single individual on their own; iii) the amount invested is especially small in magnitude; and iv) where the individual investor's personal equity stake is large. Paradoxically for investors, what attracts them to a particular team - extensive relevant industry experience - also appears to be an important source of concern to control for contractually. However, contractual specificity may also be conceivably sought by the management team to clarify what role the investor(s) should play in the venture's development, particularly if a very experienced team has opportunities to secure finance from other sources "on their terms". The added complexity of clarifying the relationship between investors participating in a syndicate and between the syndicate and the venture also implies the need for greater attention to contractual detail. The need for closer investor interaction with the venture post investment is also acutely felt in situations where relatively smaller sums of capital are at risk; ventures which are often in the formative stages of development. Establishing a clear and comprehensive contractual frame of reference also appeared to be very important for investors in such instances. Some of the most interesting insights from this study were gained by examining in some detail how the contractual approach varied dependent on "who" invested the money and "how" the capital was invested. In so doing, we are also able to speculate about the areas in which some measure of negotiating latitude may exist for entrepreneurs.

The Impact of Investor Experience on Contractual Structure

As our analysis in the previous chapter revealed, the least experienced investors (based on number of investments completed to date), generally attach a greater degree of importance to a broader spectrum of contractual safeguards than do the most active segment of the market. What is particularly interesting is that while in absolute terms, the number of contractual safeguards included in the deal up front are virtually identical across all respondents, there are some distinguishing features in particular sub-groups when the sample is partitioned on the basis of number of deals completed (see Table 7.6, page 207 for details). The most active segment of the market (10+ investments completed) is more likely to control for matters that can affect the relative level of their equity stake in the venture (raising additional debt or equity, stock option issuance) or that bind the people to the venture (non-compete contracts) or to particular forecasts (ratchets) than the least active segment of the market (less than 4 investments completed to date). Moreover, less active investors appear to want more say over operational matters such as strategic plans/budgets, senior personnel hiring/firing decisions, fixing management compensation levels, approving capital expenditure plans and countersigning cheques than the most active investors do. If there is anything to be gleaned from the most experienced investors it is this: "avoid meddling in operational matters and focus on elements that can impact the timing and value to be realized from exit".

Our study also provided potential insights in terms of identifying areas where a measure of negotiating latitude may exist for the entrepreneur in his negotiations with the investor by examining the relative differences between reported importance and inclusion ratings. To the extent that the reported proportion of respondents who considered it "very important" to include a specific contractual safeguard is exceeded by the actual proportion of deals in which it was included may be an indicator of the degree of negotiating latitude on specific points an entrepreneur may have vis-à-vis investor(s) (see Table 7.6, page 207 for full details). In general, across all sub-groups, the proportion of investors who included a given safeguard exceeded that who considered it "very important" to include on a consistent basis. However, the magnitude of the observed differences in reported proportions lends supports for the conclusion that the perceived degree of negotiating latitude an entrepreneur can exercise vis-à-vis investors across a broad range of specific contractual issues is reduced as the base of completed deals of investors increases. In other words, the least active element of the market appears, on the face of it, to be more predisposed to negotiate on specific contractual aspects of the deal with the entrepreneur, however, it should be kept in mind that this group does display a propensity to incorporate contractual safeguards related to more operational matters than is the case for the most active elements of our sample.

The Impact of Syndication on Contractual Structure

In the previous chapter, we also partitioned the sample into sub-groups based on "how" the money was invested (see Table 7.7, page 209 for details). Generally speaking, if the investor participated as part of a syndicate with other private investors, the proportion of respondents who considered it "very important" to include a specific contractual safeguard was consistently higher than was the case if the individual had invested on their own. Moreover, with few notable exceptions, more contractual provisions were included in deals involving syndicates than in those involving solo investors. In particular, syndicates attach much greater importance to and are more likely to include contractual safeguards in the following areas as compared to solo investors:

- Investor veto rights over acquisition and divestiture activity
- Approving the level of management compensation
- Investor veto rights over capital expenditure plans
- Countersigning company bank cheques

We can conclude that syndicated deals by their very nature should be more complicated as it is not only necessary to clarify the roles and responsibilities of the entrepreneur vis-à-vis investor(s) but between the investor(s) within the syndicate itself. The one notable exception is with respect to the inclusion of ratchet provisions, where solo investors were 50% more likely to include a ratchet (49% of deals) than were syndicates (34%), a reflection perhaps that syndicates are better positioned to specify a "consensus" valuation incorporating the individual assessments of a number of investors. The findings of this study support the conclusions of Landström, Manigart, Mason and Sapienza (1998) that syndicated deals are generally more complex in nature as each individual participant in the syndicate seeks to "make their impression" on the form and content of the final deal that is struck with the entrepreneur.

Relying on a similar logic as was employed with respect to investment activity, we sought to highlight potential areas where entrepreneurs may enjoy some measure of latitude in their negotiations with investors. In general, irrespective of whether the money was invested by a solo investor or a syndicate, the proportion of respondents who considered a specific safeguard to be "very important" to include was consistently exceeded by the proportion of deals that actually included the provision in the final deal struck with the entrepreneur. Based on this analysis, two conclusions can be drawn. First, the degree of negotiating latitude generally afforded entrepreneurs vis-à-vis a syndicate is lower than is the case for solo investors. Second, on operational issues (setting management compensation, veto rights over capital expenditure programs, countersigning company cheques), entrepreneurs appear to be given a greater degree of managerial discretion by solo investors than is afforded them by a syndicate of investors.

The Impact of Venture Capital Fund Involvement on Contractual Structure

We were able to examine a small subset of deals (n=12) that involved a syndicate where venture capital funds participated. The involvement of a venture capital fund opens up the possibility for private investors to participate in even larger deals than is the case for a syndicate of private investors. Working in partnership with private investors, it appears that venture capitalists can alter the unfavourable economics of classic venture capital investing by relying on the private investor to actively manage risk on their behalf. The incentives of investors are aligned inasmuch as both have meaningful sums of capital at risk in the venture. On the basis of our analysis, we can conclude, however, that involving a venture capitalist implies a much more comprehensively documented contractual deal struck up front. Accountable as they are to outside fund providers, it appears that venture capital funds do pay much more attention to the nature and form of the contract struck with the entrepreneur up front.

From our detailed analysis of the investments involving a venture capital fund (see Table 7.9, page 213 for details), a greater degree of contractual clarity was incorporated into the deal ex ante, as compared to investments involving only private investor(s), particularly in the following areas:

- Investor approval for strategic plans and budgets
- Establishing the level of management compensation
- Veto rights over capital expenditure plans
- Non-compete contracts required of management upon termination
- Investor approval required to hire/fire senior personnel

Both sub-groups placed a great deal of importance on and incorporated contractual safeguards to protect themselves from actions that could impact their relative equity stake in the venture (restrictions on ability to raise additional debt/equity finance or issue share options without investor consent). A distinguishing feature of venture capital backed deals appears to be the emphasis on "big picture" issues such as strategic plans and budgets, subjects that are often among the most important items of business in board meetings. Focussing interaction with the venture at the board level where decisions are debated and documented provides a measure of "legal cover" for fund managers in support of their efforts to signal their competence to their own fund providers. Second, it appears that the participation of a venture capital fund implies greater attention to and contractually controlling for who is in the senior management team, how they are compensated and taking steps to tie them to the opportunity by way of non-compete contracts. Having said this, one can conclude that venture capital funds are more likely to express their displeasure as shareholders by replacing management as opposed to being contractually able to force management to seek an exit. By extension, one might also reasonably draw the conclusion that venture capital funds, deeply embedded as they are into networks, face "less inefficient" replacement markets for managerial talent than might be the case for private investors.

We were able to gauge the degree of negotiating latitude an entrepreneur may have vis-à-vis a syndicate involving a venture capital fund by examining the magnitude of the differences between the proportion of respondents who considered a particular contractual safeguard "very important" to include and the proportion of deals that incorporated it ex ante. Our analysis revealed that there appears to be little scope for an entrepreneur to negotiate the contractual terms with a venture capital fund particularly in the following areas:

- Establishing the level of management compensation
- Non-compete contracts
- Veto rights over capital expenditure plans
- Senior personnel hiring/firing decisions

Moreover, some authors have suggested that the relationship between the informal and formal venture capital markets is complementary in nature (Freear and Wetzel 1990). Complementarity implies that the approach taken with respect to deal structuring is compatible one to the other. "Handing off" a deal to a venture capital fund can be achieved in two ways. First, private investors can co-invest alongside a venture capital fund from the outset thereby mitigating any future difficulties in determining how best to structure the relationship with the entrepreneur what can be termed a "parallel hand-off". We were able to tap into some of this deal flow in this study. The "hand-off" can also be achieved sequentially where private investors participate early and work with the venture to make it "investment ready" for venture capital funds to participate in follow-on rounds. Potential difficulties can arise in this "sequential hand off" to the extent that the deal structure put in place by the private investor(s) is incompatible with that called for by venture capitalists. When might these difficulties be particularly acute? On the basis of our study, we conclude that the degree of contractual incompatibility is greater between solo investors and venture capital funds than is the case when capital is provided by a syndicate of private investors. Our findings support the observation by Sohl (1999) that the "hand off" between the informal and formal markets is not only getting larger in terms of absolute investment size but implies finding ways to bring private investor syndicate backed deals and venture capital funds together.

The Motivation for Contact is Need Respondent Not Protection Orientated

Both the transaction cost economics and agency theory perspectives advocate that monitoring the behaviour of the entrepreneur is one means by which investors can protect their interests as shareholders. Based on the findings of this study, we conclude that the underlying motivation for close investor interaction appears to be not strictly as a means for investors to protect their own interests but rather one of promoting the interests of *all* shareholders. Throughout this study we have maintained that the distinction to be drawn between "protecting" and "promoting" one's interests is a fine one. However, on the basis of our findings, we can conclude that the spirit of the relationship between the parties appears to be more positive and cooperative in character than the cautious and adversarial relationship implied by either the transaction cost economics or agency theory perspectives. By inclination, private investors view active involvement in the venture development process to be an effective means of managing risk, particularly when their stakes in the outcome are personally large. The level of investor involvement post investment appears to be motivated by specific deficiencies in the management team's experience base, particularly in situations where investors are placing very small sums of capital at risk usually in the formative stages of venture development. Moreover, the presence of an investor in an employment capacity appears to facilitate the process of defining specific development needs, identifying the individual best suited to address them, and as a basis for initiating contact. Based on our findings, we can conclude that one of the key benefits of investing as part of a syndicate appears to be that investor interaction with the venture is more focused in nature. To the extent that the workload is shared within the syndicate, the time pressures faced by individual investors to reduce their contact with other ventures in their portfolio is mitigated.

Active involvement also appears to imply that contractual safeguards be included up front to clarify the rights and obligations of all parties to the exchange – establishing the "rules of the game" so to speak. These findings lend support to the interpretation of Landström, Manigart, Mason and Sapienza (1998) who noted that one of the purposes of establishing a contractual framework up front is to provide a basis for the development of a relationship between the parties to develop over time. The importance of the relationship as a mechanism for dealing with future challenges is also supported by the observation that investors tolerate a degree of contractual ambiguity by not including specific provisions outlining the manner in which future disputes are to be resolved at the outset.

Interpersonal Trust: A Necessary Transactional Lubricant

In the absence of efficient markets for pricing and liquidating equity stakes in privately-listed firms and for entrepreneurial talent generally, a necessary transactional prerequisite appears to be the existence of a high degree of mutual trust between the parties. The impact of trust manifested itself in two important ways. First, in situations where deal referrers were personally knowledgeable of the proponents involved *and* their judgement and opinion was trusted by the investor, the nature of the contractual deal struck with the entrepreneur was demonstrably less restrictive. We can conclude that deal referrers appear to perform a very important role in shaping the investor's perception of the underlying agency risk associated with a given proposition. To our surprise, we discovered virtually no direct relationship between our interpersonal trust construct and the dependent variable CONTRACT. While trusted referral sources appear to positively impact the perceived level of trust an investor has in a management team, this impact appears to be offset by the need to establish a transactional framework to define the roles of all parties with greater contractual clarity. This guiding framework for co-operation appears to be especially important to investors when their stake in the business is relatively large. Second, we found that the level of interpersonal trust mitigated the need for investors to maintain especially close contact with the venture post investment. It would appear that two important bases of trust for investors is the extent to which entrepreneurs bring greater levels of general management and new venture experience to the table than themselves. This observation lends further support for drawing the conclusion that the level of contact is motivated by specific venture development needs and not strictly by a desire of investors to monitor agent behaviour.

The findings of this study support the growing body of received research that private investors are attracted to situations in which they can "add value" (Mason and Lumme 1995) and that the relationship between the parties is positive in character (Landström 1992). It appears that investors seek to establish a governance framework that is co-operative in nature (Cable and Shane 1997) and in so doing thereby promoting the interests of all shareholders, including themselves.

Are "Informal" and "Market" Appropriate Descriptors?

In the venture capital context, the modifier "informal" conjures up an image of transactions devoid of lengthy contracts and where deals are consummated "on a handshake". Without institutional fund providers to be accountable to, private investors conceivably could invest their own money with few or no "strings attached". However, the findings of this study support the conclusion that investors do seek a measure of clarity up front as to how their relationship with the entrepreneur is to be structured and that this understanding is embedded in contractual form. In this sense, the purpose of the contract appears to be as a "guiding framework" rather than "legal protection". We did find that deals involving a venture capital fund implied a more comprehensive contractual agreement up front with the entrepreneur as compared to those that involved the participation of private investors only. We can conclude, however, that as the base of investing experience of an individual increases *or* the investment is made by a syndicate of individuals, the distinction between the "informal" and "formal" segments of the venture capital market, from a contractual perspective, begin to blur. Having said this, we were struck by the sheer magnitude of time investors across the sample anticipated spending interacting with the venture post investment. Even in situations that involved a venture capital fund, investors anticipated spending, on average, more than twelve hours per month interacting with the venture *and* in half of these instances, at least one investor was to be employed in the venture in some capacity.

To properly address the question of degree of formality, we need to clarify on what bases an assessment can be made and how deals that involve private investors only differ in character from those involving a venture capital fund. In an earlier section, we maintained that unlike private investors, venture capital fund managers have a fiduciary duty to their own fund providers. In fulfilling this obligation, we can expect that the nature of the contractual deal would be more comprehensive and that venture capitalists would likely focus their interaction at the board level where debates and discussions are documented and of legal force. We have already demonstrated that the contractual deal struck with the entrepreneur is more comprehensive and restrictive in nature than is the case when only private investor(s) are involved. As to the issue of the reliance investors place on working in a more formal capacity at the board of directors level, one possible indicator is to examine the balance of power (and interests) on the board. To the extent that investors retain a greater proportion of board seats for themselves or their representatives may be interpreted as one indicator of the reliance they may have on this "formal" instrument for directing management behaviour in desired ways. On average, management retained a controlling proportion of the board seats in situations where the capital was invested by a private investor on their own (68% of seats) or by a group of private investors (51%). However, when a venture capital fund was involved, investors maintained, on average, a controlling proportion of 52% of the seats. On the basis of the foregoing, we can conclude that the "informal" descriptor is an appropriate one, although, as we noted earlier, the distinction between the informal and formal segments of the markets begins to blur as private investors form syndicates among themselves. One can speculate that the observed differences in approach between private investors and venture capital funds may reflect a response to the underlying "market" conditions each faces. It is to this issue that we now turn our attention.

In Chapter 3, we highlighted in what ways the informal venture capital "market" is similar to, and differs in character from, the term "market" as espoused in both the transaction cost economics and agency theory perspectives. In particular, we drew attention to the fact that by investing in a highly illiquid instrument, private investors are effectively denied one possible option to signal displeasure with the actions of management, that is the ability to sell their shares at fair market value expediently. Moreover, as individual entrepreneurs are so closely tied to the opportunity being pursued by the venture, it may be exceedingly difficult for investors to find suitably qualified replacements for management in most instances (Cable and Shane 1997). It is reasonable to suggest that the ability to cope with this "replacement problem" is a function of the breadth and depth of one's network of contacts.

The task of developing such a network of contacts should be greatly facilitated in the highly visible formal segment of the market as opposed to the largely discrete and invisible informal one. In other words, there is reason to believe that private investors will encounter greater difficulties in identifying suitably qualified replacements for an entrepreneur than would venture capital funds. Moreover, this difficulty is probably most acutely felt by relatively inexperienced investors who are both building a portfolio of investments and a base of contacts to further support their investment activity over time (Kelly and Hay 1998). In the absence of either efficient markets either for their equity stakes or for entrepreneurial talent, one can conclude that close interaction with the team post investment may be the only feasible response of private investors to the idiosyncratic market conditions they face. Having said this, it is understandable why investors display a proclivity for investing in situations where their experience and contacts can bring tangible value-added benefits to the venture. What implications do these observations about the nature of the term "market" have in terms of the utility of the two theoretical perspectives we relied upon for hypothesis development is the issue to which we now turn our attention.

Are Transaction Cost Economics and Agency Theory Appropriate Lenses?

Both the transaction cost economics and agency theory perspectives did prove useful to a point in lending a degree of structural underpinning for the development of our model. As a basis for examining the choices investors make as to how to structure their relationship with the entrepreneur, both perspectives helped to provide focus in terms of thinking through the implications of asymmetric information distribution between the parties and of the specific attributes of the transactors and the investment itself. For reasons discussed at length in Chapter 3, we believed that both theoretical lenses may be inappropriate in the domain of the private investor in view of the absence of efficiently operating markets for either equity stakes in privately and closely held firms *and* for suitably qualified managerial replacements. What conclusions can be drawn about the utility of these theoretical perspectives in the informal venture capital field? We shall address each in turn.

For transaction cost economists, the mechanism of choice to curb opportunistic behaviour is contracts. Ideally, the contract should be highly specific, cover all possible contingencies, outline a formal basis for resolving disputes going forward and be in a format that can be monitored and legally enforced. In a sense, this approach to governing economic relationships is probably most appropriate for transactions of short duration, where tangible product is exchanged, and suitable replacement options can be readily identified. The nature of the transaction between private investor and entrepreneur appears to be fundamentally different in character involving long duration, exchange of skills that are largely intangible in nature, and where suitable replacements are difficult to find on both sides of the dyad.

On the basis of our study, the underlying purpose for a contract appears to be in establishing a framework for how the parties will work together going forward as opposed to strictly being a mechanism to protect investor's interests as shareholders. Our sense is that private investors intend to be and are more actively involved with their investee companies in a broader range of capacities than is the case for prominent shareholders in publicly-traded firms. Clarifying roles and responsibilities from the outset appears to be the major motivation for developing a contract in the first instance. Moreover, we observed that a degree of contractual ambiguity appears to be tolerated up front by investors, particularly in terms of the way future disputes are handled. From the outset, the relationship between the parties appears to more positive and trusting in character than the inherently adversarial one implied in transaction cost economics. Whether investors rely on contractual safeguards and enforce their contractual rights legally when a rough patch is experienced vis-à-vis the entrepreneur was beyond the scope of this study. The utility of the transaction cost economics perspective would increase immeasurably if future research were to demonstrate that private investors actually rely on the contractual agreement to assert and are prepared to legally enforce their rights as shareholders. Our sense, however, is that private investors look to the relationship that develops between them and the entrepreneur to resolve difficulties as they are encountered, a view that does not resonate strongly with the spirit implied by transaction cost economists. To the extent that this line of reasoning holds, we conclude that the transaction cost economics perspective may be of limited utility in the domain of informal venture capital. Is the agency theory perspective better suited and more appropriate in this context? It is to this issue that we now turn our attention.

For agency theorists, the mechanism of choice for curbing opportunistic behaviour lies in the design of the incentive system. We argued in Chapter 3 that the incentive-based focus of agency theory holds an intuitive appeal to entrepreneurial ventures. However, like transaction cost economics, the relationship between the parties is inherently adversarial in nature as agency theorists maintain it is difficult to ascertain the veracity of claims made by agents about their level of competence and behavioural intentions towards the principal. Moreover, there is an assumed hierarchy of power that always favours principals (investors) over agents (entrepreneurs). While we did find support for the central tenet of agency theory, that a positive relationship exists between the size of equity stake retained by principals and the level of contact maintained with the venture post investment, the result was only modestly statistically significant ($p<.10$). If principals are engaging in diligent monitoring activity we should have expected to see a much more significant relationship than we did. As was mentioned previously, the underlying motivation for close investor involvement in the venture appears to be driven by specific venture development needs and not by an apparent need for investors to keep "close tabs" on management. Active involvement was not only regarded by investors as an effective means of managing risk, but also appears to be a means by which investors bring complementary skills and experience to bear on the development of venture. In this respect, the relationship between principals and agents appears to be more cooperative and positive in nature than agency theory would imply.

Having said this, we should not dismiss the potential utility of agency theory out of hand. One of the important contributions of van Osnabrugge's (1999) research was to distinguish between two streams of agency theory, the "principal-agent approach" whose objective function is "optimal contract design" and the "incomplete contracts approach" whose objective function appears to be one based on "crafting flexible frameworks". The findings of this study lend support to van Osnabrugge's conclusion that the "incomplete contracts approach" appears to be better suited to the informal venture capital context than the "principal-agent approach". If, as it appears, investors place heavy reliance on their relationship with the entrepreneur to deal with future governance challenges, the relational dimension of governance takes on added importance in the domain of informal venture capital. Having said this, we can also conclude that further theoretical development in the field would greatly benefit from the synthesis of agency theory with other more relational perspectives such as procedural justice (Sapienza and Koorsgaard 1996). Future research efforts can build upon this study in a number of ways. It is to this issue that we now turn our attention.

8.3 Directions for Future Research

Informal Venture Capital

For the field of informal venture capital, there are a number of potentially fruitful directions for future research enquiry. First, in providing a theoretically grounded framework together with a survey instrument, there is scope to replicate this study both in the UK and, in particular, in other countries. The largely invisible nature of the phenomenon under study necessitates extensive replication of studies particularly if we are to make advances in terms of the theoretical development of the field generally.

Second, our study proceeded on the basis of an important implied assumption, namely that the opinions of investors matter more. There is an obvious intuitive appeal for the notion that, in the final analysis, it is the investor who chooses to invest and on what terms and conditions. However, there may also be reason to believe that entrepreneurs, particularly those that have started a number of successful businesses, can also exercise a measure of negotiating leverage vis-à-vis investors in terms of how their relationship with the investor is structured. Some authors have maintained that entrepreneurs may also feel it necessary to build in measures to protect their interests from potential opportunistic behaviour on the part of investors (Landström, Manigart, Mason and Sapienza 1998). The economic relationship between investor and entrepreneur involves two parties and it is necessarily incomplete to rely strictly on the views of only one. Significant insights can be gained particularly from serial entrepreneurs who have a breadth of experience raising external capital and managing relationships with resource providers. The ability to identify the sources of relative negotiating power from both sides should help us to better understand why private equity transactions are structured the way they are. Moreover, by incorporating the perspectives of both investor and entrepreneur in a matched-pair design, our ability to identify potential sources of bias and addresses issues related to construct validity and reliability could be greatly enhanced.

Third, while there is growing appreciation that syndication among investors is a prominent market feature, very little is understood about how syndicates form around a specific deal and the dynamics associated with agreeing to terms within the investor group itself. In our study, we scrutinized the data to ensure that respondents were commenting on unique deals. By tapping into the views of all syndicate participants, we can gain a better understanding of how individual preferences shape the final form of the deal (Landström, Manigart, Mason and Sapienza 1998) and the impact of the underlying process investors rely on to reconcile their individual views.

Fourth, the establishment of transactional parameters and determining the intensity and form of investor involvement in the venture development process going forward can be viewed as necessary first steps to establish a mutually productive working relationship with the management team. While there appears to be significant incentives for the parties to cooperate over the longer term (Cable and Shane 1997), the potential for problems to occur post investment is ever present. A number of important questions remain unresolved. To what extent is the relationship between the parties relied on as a means for adapting to change and/or dealing with unanticipated problems? When does it make sense for an investor to invoke their rights and how do they and should they invoke them? How is the subsequent relationship between the parties impacted by decisions taken in the pre-nuptial stage? In what areas does it make sense to build in contractual ambiguity up front?

Fifth, and this point follows from the previous one, assessing the degree to which private investors rely on relational as opposed to more discrete transactional safeguards to promote and protect their interests (Macneil 1980) implies that the potential utility of other theoretical perspectives should be explored. A recent study by Landström, Manigart, Mason and Sapienza (1998) relied on social exchange theory in addition to agency theory as a basis for generating a series of testable hypotheses. Moreover, there is a growing interest in examining the applicability of the procedural justice perspective to entrepreneur-venture capitalist relations (Sapienza and Koorsgaard 1996).

Sixth, the issue of whether the informal and formal venture capital markets are as complementary in nature as we think needs to be revisited. We were able in this study to examine a small sub-set of deals where private investors had invested alongside venture capitalists. The nature of the contractual deal struck with the management team was notably more explicit when a venture capital fund was involved. Complementarity implies that the structure of the relationship struck by private investors is compatible with that required by venture capitalists. In view of the differences in approach highlighted in this study the question remains, are the two markets in fact compatible? How is the relationship between the parties altered when a venture capitalist is brought on board? Is a highly formalistic contractual approach adopted by venture capital funds more effective than the more engaging and less formal approach typically adopted by private investors? Does it make more sense for venture capital funds to invest alongside private investors from the start or follow-on after them?

Seventh, our study highlighted some of the differences in approach that exist between the least active and most active segments of the informal venture capital market. We attributed these differences, in part, to the greater breadth and depth of the network of contacts available to investors who have completed numerous private equity transactions. Is this assertion in fact true? How do private investors go about building a network of contacts? What types of contacts matter most and when? How should less experienced and particularly virgin investors develop their network of contacts? Who should facilitate this development process and is there a role for the public sector?

Industrial Economics

The development of both the transaction cost economics and agency theory perspectives has depended, in large measure, on understanding the governance challenges faced by large, publicly-traded firms and prescribing effective remedies to deal with them. Compared to prominent shareholders in "big corporates", investors in private companies are effectively denied the option to express their displeasure with management by either selling their equity stakes or by replacing incumbents. Faced with these unique challenges, it is understandable why private investors appear to adopt a more "hands on", engaging and intense personal relationship with management than may be the case in publicly traded firms (Bhide 1994). Is there any lessons to be learned from the way private investors work with their ventures that could apply to prominent shareholders in public companies or vice versa? After all, the expectation going in for many private investors is to help create the next Microsoft (a BIG corporate).

The case for transaction cost economics would be greatly strengthened if further research is undertaken to confirm that investors do invoke and enforce their legal rights specified in the contract. Why do transactions break down? When does it make sense to seek remedy by invoking contractual safeguards? For that matter, what provisions matter most? How should flexibility be built into the arrangement? By addressing these issues, we are better positioned to move away from a focus on "optimal" as opposed to "workable" contracts.

A particular stream of agency theory, "the incomplete contracts approach" (van Osanbrugge 1999), has usefully recognized the limits of contractual specificity. Having said this, our study highlighted the importance of interpersonal trust as a transactional lubricant. In failing to account for the role of trust, agency theory is "undersocialized" (Granovetter 1985). Future research should explore means of integrating the notion of relational contracts (Macneil 1980) and other theoretical perspectives such as procedural justice whenever possible. Private equity transactions hold out great promise in this regard.

Moreover, one of the key insights of Cable and Shane (1997) was that agency theory should be usefully considered as a subset of prisoner's dilemma. Modeling relationships in such a manner has an intuitive appeal as the focus of the exercise is to understand how parties can work towards seeking a cooperative solution. In addition, prisoner's dilemma does make the restrictive assumption of agency theory that principals necessarily have more power than agents as is implied when framing the relationship in hierarchical form. While they developed their framework as a basis for understanding venture capital backed deals, to what extent are the observed relationships different when private investors are involved? What are the bases of power for investors and entrepreneurs and what impact does this have on the structure of the relationship between the two? What are the implications of similarities or differences in approach between the formal and informal venture capital markets for further promoting the complementary relationship thought to exist between them?

8.4 Implications

Entrepreneurship research, by its very nature, is applied in orientation and thus strives to make a difference "in practice". In what ways did this study "matter" to practitioners? We shall briefly draw out the practical implications of this research project for private investors, venture capitalists, entrepreneurs and public-policy makers in turn.

For the less active and, in particular, the substantial pool of investors who have yet to complete their first private equity transaction, this study has afforded a number of significant insights. By tapping into a reasonably large base of deals, we were able to provide a reference point for individuals to "benchmark" their approach to deal structuring with that of their active peers in the market. In so doing, we discovered, however, some fundamental differences in approach dependent on "who" was investing and "how" the capital was invested. The most active element of the market were significantly more concerned about and contractually controlled for management actions that could impact the size of their equity stake in the venture and, to a lesser extent, the timing of exit, than their less experienced counterparts. Moreover, as a negotiating tactic, the most active investors appear to favour the use of ratchet mechanisms to tie the entrepreneur's stake to a set of projections and are more inclined to tie them to the business by way of a non-compete contract. The least active segment appears to not have drawn as clear a distinction between the roles of "investor" and "manager" in view of their inclination to seek more control over more operational issues in the contract struck up front. This transition may be an especially important one for investors to make if their intention is to have the venture seek follow-on finance from a venture capital fund. In this respect, the most experienced investors appear to be the most compatible in terms of "operating style" to venture capitalists than is the case for less experienced investors. Aside from the obvious of advantages of being able to participate in bigger investments and in a larger number of deals, syndication also appears to afford the opportunity for individuals to: i) focus their involvement with the venture in high impact areas, particularly where an investor is well placed to "direct traffic" as an investor-employee, ii) benefit from the input and involvement of other investors to the deal, and, as result, iii) ease the time commitment required of them. Importantly, however, private investor syndicate backed deals appear to be more compatible to, and better positioned for, venture capital funds to invest in follow-on stages than ventures that are backed by a solo investor. In this respect, syndication may be one promising avenue to address the illiquidity trap implied by under-funding company growth. Of perhaps greater significance, to the extent that syndication activity affords individuals the opportunity to broaden and deepen their network of contacts, management replacement may become a more viable option for investors if circumstances warrant such a move.

For venture capitalists, this study has afforded a number of insights into the issue of how the formal and informal venture capital markets can work closer together in a complementary fashion. Complementary implies, however, that a degree of compatibility exists in terms of the approach to deal structuring. Our study highlighted that some segments of the informal venture capital market appear to be "more compatible" than others. The nature of the deals that are struck between private investor syndicates and/or more experienced investors and entrepreneurs are more similar in their complexity and focus to venture capital funds than is the case for solo or less experienced investors. By focus, we mean particular attention being paid to and contractual provisions included for issues that could impact the size of equity stake retained by investors and determining who should drive the venture's development going forward. Moreover, the board of directors appears to take on added prominence as a formal mechanism for investor interaction with the venture either in terms of increased absolute size or the proportion of seats that are allocated to investors in situations where a syndicate or very experienced investor is involved. Having said this, the implication for venture capital funds that desire to increase their links to and participate in follow-on rounds with the informal market are well advised to develop their base of contacts with syndicates and the most experienced element of the market in the first instance. The sequential investing model is but one way that the formal and informal venture capital markets can work together. We were able to collect data from a small number of deals that involved a venture capital fund co-investing alongside private investor(s). Leveraging the knowledge and experience base of the private investor does hold an obvious appeal as a means for addressing the diseconomies associated with classic venture capital investing. Private investors appear to have both the experience, and more importantly, the time to interact very closely with the venture in a "hands on" capacity. By alleviating the need for fund managers to involve themselves in "nitty gritty details", the venture capitalists are better positioned to provide strategic input particularly at the board level. Moreover, co-investing also solves the compatibility issue from the outset. Irrespective of whether venture capital funds "follow-on" or "co-invest alongside" private investors, strengthening the linkages between the formal and informal venture capital markets is imperative because the activities of each are not only complementary in character but appear necessary for both to flourish. In short, venture capital funds depend on a thriving informal venture capital market to create a growing stable of investment ready propositions. Similarly, private investors need the skills and experience of venture capital funds in spurring the growth of entrepreneurial ventures thereby creating a stable of businesses upon which to realize the value they helped to create. Having said this, the British Venture Capital Association and business introduction services are well positioned to play a pivotal role in broadening and deepening the relationship between the two markets.

For entrepreneurs, this study begins to highlight the importance of some of the factors investors take into account in determining how to structure their relationship with you. Informal venture capital does come with contractual "strings attached". In part, the contract between you and the investors should be viewed as a framework for co-operation between the parties particularly as investors are inclined to be very actively involved in the development process in any event. Approaching more experienced investors and/or syndicates implies a tighter focus being placed on issues related to ownership structure and management team composition. In such situations, entrepreneurs appear to have little negotiating latitude on these issues vis-à-vis investors, however, they are afforded a greater zone of managerial discretion by them. Less experienced and/or solo investors appear to want greater contractual clarity on a broader array of issues, more input on what might be considered "managerial" issues, but are more inclined to negotiate with the entrepreneur than is the case for deals involving more experienced investors or syndicates. The shape of the contractual deal also appears to be influenced by what we have termed the "investor's paradox". On the one hand, investors seek to back people who have relevant industry experience, but, on the other hand, their own lack of experience in the same industry is a primary source of concern for them to control for contractually, particularly for solo investors. "Which investor to approach" appears to be not nearly as important an influence on the structure of the contractual deal as "how to approach them". This study has highlighted the importance of making the approach through a referral source that *knows you* and whose judgement and opinions are *trusted* by the investor. The key question for entrepreneurs when deciding how to approach is not: "who do you know?" but rather "who trusts you?". As to whether investors actually rely on contractual agreements to assert and defend their rights as shareholders is an open issue. Having said this, the findings of this study support the assertion that the level of anticipated investor contact with the venture post investment is motivated by specific venture development needs as opposed to strictly being a mechanism by which investors can "check up" on the entrepreneur. The value added input of investor involvement implies, however, a degree of clarity between the parties as to the nature of the venture development needs, identifying who is best placed to address them, and in so doing, specifying the roles and responsibilities of all parties to the exchange. In this sense, the working relationship that develops between the parties over time may be the most appropriate means for maintaining the necessary degree of flexibility to successfully adapt to change.

For policy-makers and, by extension, managers of business introduction services and other facilitating organizations, this study has tapped into the experience of a broad range of respondents on a deal specific basis. By enhancing our understanding of how the relationship between investor and entrepreneur is structured and more importantly by identifying some key factors that shape these choices, we are better placed to develop educational and training materials for two significant groups, investors who have yet to complete their first deal ("virgin investors") and entrepreneurs who are thinking about raising equity but have not as yet done so. Learning from experience may inspire confidence among some virgin investors to make their first investment. However, as we noted, the operating style of the most experienced investors and syndicates is quite different to that of less experienced and solo investors. This observation takes on added import to the extent that the approach of the former is more compatible with venture capital funds than that of the latter. In this respect, facilitating the formation of investor syndicates that involve both active and inactive participants holds out promise as a mechanism for virgin investors to "learning by doing" and, as importantly, for increasing the size of the "venture capital ready" investment pool. Business introduction services also appear to be well placed to foster the further development of linkages between the informal and formal markets. In trying to answer the question "why" investors choose to structure their relationship with the entrepreneur in the way that they do, it was our hope that some entrepreneurs would be encouraged to think about raising equity to support the growth and development of their businesses. We are under no illusion, however, that deal specific information alone would redress the widely-held perception that the terms of exchange are "inherently unfavourable" for entrepreneurs. Having said this, there is a pressing need to facilitate networking among entrepreneurs who have raised external equity and those that aspire to do so.

Of one thing we can be certain, it will take sustained and persistent effort to fully address the ailment known as the equity funding gap. As with many ailments, we never seem to have enough background research to find a cure. If the findings of this study serve to stimulate the supply, and more importantly, the demand for private equity, we may have taken a step, albeit small, in the direction of finding one. Over the long term, creating the right environment and changing perceptions are the keys to closing the equity gap and realizing the full potential from a thriving informal venture capital market.

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