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Editorial

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Editorial

This Special Issue of the Journal of Entrepreneurial and Small Business Finance is devoted to Early Stage Venture Capital. I wish to place on record my thanks to the authors of all the papers submitted. The resulting selection contains five articles covering subject matter from the United States, Finland and the United Kingdom, and discussing both conceptual and empirical issues. The international and conceptual coverage is eloquent testimony to the extent to which the study of early stage venture capital has developed in recent years.

A series of conferences on the "state of the art in entrepreneurship" has been held at approximately five year intervals since 1981. The conference proceedings provide an indication of the quantity and nature of research undertaken over the years in the field of entrepreneurship, including the market for venture capital. At the first conference in 1981, around twelve studies were identified on the venture capital market, and almost all related to the United States. At the 1986 conference, about twenty "venture capital" studies were reported as having been published since 1981. Again, these were based on United States data. About half of the venture capital studies published in the early 1980s dealt primarily with aspects of the "informal venture capital market." By the time of the next conference in 1991, a further thirty papers on the informal venture capital market had been published. These were mostly based on United States data, although research studies were by then being published in the United Kingdom. By the 1996 conference, some forty papers on the informal venture capital market had been published since 1991, of which half were from Europe, particularly the United Kingdom.

The first paper in this special issue is by Busenitz and Fiet, who relate the early stages of the financing of a business to exit strategy. They examine the relationships between venture capitalists' actions and the initial public offering (IPO) exit strategy, by employing longitudinal rather than the more common cross-sectional methodology. Using data from two hundred and five ventures that had received at least one round of venture capital funding between 1987 and 1989, the authors collected venture disposition data in 1995. They placed the data in four categories: "no longer in business," "the living dead," "merged or acquired," and "IPOs."

Busenitz and Fiet find only mixed results for relationships between IPO exit and situations in which venture capitalists owned more than half the venture, and between IPO exit and venture capitalists introducing their investees to other sources of funding. There is, however, a positive relationship between IPO exits and both the amount of venture capital investment and the degree of diversification of the venture capitalist syndicate. The authors argue that venture capitalists will decide to invest larger amounts in a business if they are able to satisfy themselves about the business's specific risk-reducing investments. This notion differs from

the staged investment approach in which venture capitalists hedge bets on the venture by increasing over time (or abandoning) their investment as the soundness (or otherwise) of the business becomes clearer.

Busenitz and Fiet suggest that increased syndication is positively related to long term venture outcome: the more syndication, the greater the likelihood of an IPO. They base this hypothesis on two assumptions. First, they assume that larger syndicates will be better informed. Second, larger syndicates are likely to do a better job of monitoring a business's management team and so will tend to reduce the chances of the team acting in a self-interested and/or incompetent manner.

Keeley, Punjabi and Turki examine from a different angle at least one of the issues raised by Busenitz and Fiet, notably the staging of financing as a hedge. Keeley *et al.* discuss the valuation of early stage ventures, comparing and contrasting option-based models with the more traditional models, the discounted cash flow method and the venture capital "rules of thumb." The options method assumes multiple stage investments by venture capitalists, each additional funding stage being influenced by the performance of the business. The discounted cash flow method assumes that follow-on investments will always be made, regardless of the business's performance. Consequently, it tends to understate the net present value of the business, whereas the option model tends to set the upper limits to value.

The option model seems closely to replicate the venture capitalists' "rules of thumb," according to the findings of Keeley *et al.* Additional advantages that may accrue to the option model, however, are that it is applicable to new situations that by definition have no "rules of thumb" in place, and that it may be applied by those who handle very few investments each year, for example, business "angels." It might also be used by entrepreneurs themselves in preparation for negotiations with potential backers.

Exit strategies are a key element in the paper by Lumme, Mason and Suomi. They surveyed 38 active angels in Finland who had made a total of 155 investments. Twenty of the investors had made 49 exits. The study's methodology builds on the experience of other studies of business angels, all of which have had to deal with the desire of angels to maintain anonymity. First, it presents evidence on investment performance and on the timing and method of exit. Second, it explores differences between investors with successful and unsuccessful exit strategies. The authors find that the investors achieved a positive return on only about one-third of their investments, although about one fifth of the investments generated an internal rate of return of over 20 percent. The data show that "successful" investors have the following profile: they have spent more of their career in top management positions in large corporations and in middle management positions, whereas "unsuccessful" investors have spent longer in top management positions in small companies; successful investors are motivated more by fun and satisfaction

derived from entrepreneurial ventures than by altruism and social responsibility; the successful have a larger flow of candidate investments but made fewer investments; friendship with the entrepreneur is a more common prior condition in the case of the unsuccessful investor, and they have a high estimation of their own value-added contribution to the business in which they invested.

The authors make concluding comments on a future research agenda, observing that angels are likely to be less concerned with the relatively remote possibility of an IPO exit strategy than with a "trade sale," which is the dominant exit method in their study. Interesting questions arise as to the reasons for this finding, and the authors speculate on several. In addition, they discuss related issues, such as the timing, the identification of the buyer, pricing, and the degree of congruity between angel and entrepreneur with regard to exit objectives.

Kelly and Hay focus on the early stage investment activity of serial investors, whom they define as individuals who have made at least three private investments. Serial investors are of particular interest because it is likely that these investors account for most of the private equity investment activity; because there may be a "learning curve" in operation; and because an understanding of the active investor may offer insights into how to stimulate inactive investors into making investments. They identify two distinct groups, "solo" serial investors, who invest on their own all the time, and "syndicate" serial investors, who work almost exclusively with other investors.

Kelly and Hay discuss the apparent divergence between conventional finance theory that suggests that business risk can be reduced through diversification, and the inclination of private investors to reduce business risk by acquiring risk-reducing information on specific investment opportunities, and by seeking to manage agency risk. They advance several hypotheses and test them against data from a very small convenience sample of serial investors. They conclude, *inter alia*, that some measure of diversification by industry can be achieved through syndication. Entrepreneurs seeking informal venture capital must be able to communicate clearly and unambiguously to the "right" investor (preferably someone whom they know) the investment's risk and return potential. Their study finds that serial investors tend to invest in early stage ventures and that the extent of syndication in the U.K. is greater than previously thought. Further, investors invest in industries in which they have limited or no direct experience and that agency risk is managed to some extent by backing entrepreneurs who are known to the sole investor or a syndicate member.

The final paper, by Gittell, Sohl and Thompson, explores early stage venture capital from a very different perspective from the other papers. The authors examine the additional problems faced by entrepreneurs in low-income and minority neighborhoods in securing funding. It is not uncommon, of course, for entrepreneurial ventures to face funding problems. Location in the inner city compounds

these problems, given high crime risks, limited local buying power and racial discrimination. Inner city and low income entrepreneurs tend not to be "plugged in" to informal capital networks, and have little or no access to private investors. Gittell *et al.* put forward the notion of an expanded role for private foundations as "community development venture capitalists," using as a case study the Neighborhood Entrepreneur Program (NEP) in New York City. The NEP is a joint effort of the NYC Partnership (a privately funded not-for-profit organization with many Fortune 500 companies among its members) and its subsidiary the NYC Housing Partnership, the City of New York's Department of Housing Preservation and Development, and the Rockefeller Foundation.

The paper's preliminary findings indicate that the return from investment and related activities by foundations includes supporting businesses, serving an "under-served " population, helping to enhance the quality of life of residents in the neighborhoods and their opportunities for employment, and contributing generally to community improvement. The experience with NEP further suggests that there are benefits from private foundations and other community-oriented organizations complementing their traditional grant-making with indirect and direct investment in selected private ventures. Through its participation in the NEP, the Rockefeller Foundation has begun to help entrepreneurs acquire industry knowledge and contacts, as well as providing grant-funded infrastructure and direct investment in businesses. Thus, it is acting in a way somewhat similar to many venture capitalists and private investors in providing a value-added component of expertise and contacts, overlaid however by infrastructure improvement, as well as in providing risk capital. The overall intent is to blend market incentives with community goals.

The papers included in this special issue advance our knowledge and understanding of an area of inquiry—early stage venture capital—that is becoming increasingly recognized as crucial to strong long-term economic growth and development. We must continue, through our research and its dissemination, to make the market in which early stage ventures operate more efficient, understandable and effective. There remains much work to be done.

John Freear