Support Strategies in Venture Capital Financing

Nurturing or Selection

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ABSTRACT

Venture capitalist are intermediaries with strong advantages in financing risky investments (Leland/Pyle 1977, Chan 1983, Diamond 1984; Bygrave 1988). Being specialized in one industry, venture capitalists can control risk at lower cost compared to other players in the market (e.g. banking houses) because they have accumulated specific know-how, experience, as well as access to networks and information. Norton and Tenenbaum (1993a) found evidence that controlling portfolio risk through specialization in certain industries and in certain financing stages seems to be a superior strategy for venture capitalists.

Their results seem quite plausible. However, practical evidence shows that we not only find "specialists" in the market but also other venture capitalists that are not specialized either in industries nor in finance stages. We call them "all-rounders". We are puzzled by the existence of all-rounders because it seems to be unclear what sort of advantages they could realize in the mar-ket.

In attempting to answer that question we try to find out in how far all-rounders differ from specialists. We assume that main differences are caused by the sort of knowledge that all-rounders and specialists own. Whereas specialists have knowledge or know-how concerning a certain field (e.g. biotech) plus important know-how in founding and financing activities, all-rounders only have know-how in founding and financing activities. In consequence all-rounders are likely to choose a different sort of enterprise for their portfolio as well as a different sort of strategy to support their portfolio enterprises. Based

on an agency theory rationale we estimate the information cost for specialists and all-rounders to choose a certain type of enterprise and to embark on a certain support strategy. We assume that all-rounders will support their portfolio enterprise very intensely (nurturing strategy) whereas specialists will focus on careful selection. With regard to support they will rather control than nurture (selection strategy). The rationale is the following: Compared to venture capitalists, entrepreneurs pursuing highly specialised tasks like bio or gene technology possess systematically superior know-how regarding the project. Nevertheless, the venture capitalist's specific knowledge provides effectual 'absorptive capacity' (in terms of 'enough knowledge to understand the business processes') to control the founder. Furthermore, it enables him to assess the market adequately. Consequently it is more efficient for him to allocate his specific knowledge on selection (and controlling) processes rather than on nurturing processes. Altogether, compared to other investors (private investors or banks), a specialist who chooses the selection strategy can handle investment risk in a superior way. In contrast, a venture capitalist possessing general knowledge like 'how-to-manage-an-enterprise' can offer nurturing as a complementary asset to the founder if the founding project is not too complex and easy enough to understand.

We have tested our theoretical results empirically with our own dataset, which was collected from venture capitalists associated in the German Venture Capital Association e.V. (BVK), the Swiss Private Equity and Corporate Finance Association (SECA), and the Austrian Private Equity and Venture Capital Organisation (AVCO) in February, March, and May 2003. Our first empirical analysis has yielded evidence that our hypotheses could be sustainable.

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