Chapter 8
Opening the Black Box of the Venture Capital–Entrepreneur Relationship: Evidence From a Process Study

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ABSTRACT

This chapter aims to explore in-depth the relationship between the venture capitalist and the venture-backed company and account for how this relationship unfolds over time. To achieve this, the authors present evidence from three process case studies. The field study presented in this chapter is partly retrospective and partly in real time and is based on two rounds of focused interviews with the entrepreneurs and the venture capitalist. The findings show that several factors play a role, with confidence in the VC (Venture Capital) being essential to beginning the relationship and trust between the parties being essential to continuing it successfully. This relationship is a learning experience for both parties: while the entrepreneur becomes acquainted with the tools for daily, as well as strategic management, the venture capitalist learns how to effectively scout new attractive business ideas.

INTRODUCTION

Venture Capital (hereafter VC) is a widely used form of financial intermediation that is particularly well suited to support the creation and the growth of young entrepreneurial companies (Hellmann & Puri, 2000). Apple, Genentech, Microsoft, and Intel are just a few, widely known examples of venture-backed

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companies. VC has distinctive features from more traditional capital markets or debt financing alternatives (Gompers & Lerner, 2001). Zider (1998) outlines how VC fills the void between sources of funds for innovation and traditional lower cost sources of capital. Such a void exists due to the structure and the rules governing capital markets. Traditionally, bankers only finance a new business that has hard assets against which to secure their debt. In today's economy, which is largely based on intangible assets, this would limit the creation of start-ups. Investment banks and private equity funds are also constrained by several operating rules that protect public investors. This is the context in which VC positions itself and plays a key role in stimulating job creation, innovation, and economic growth (Kortum & Lerner, 2000).

High information asymmetry (Petersen & Rajan, 1995) and high uncertainty documented in the organisational ecology literature and reflected in the liabilities of newness and smallness (Hannan & Freeman, 1989) typically limit a startup's access to traditional financing sources. In contrast, VC firms have the capabilities required to address these factors and contribute to the management of startups. VC firms devote significant management resources to understanding new technologies and markets, to identifying promising startups and providing them with financial resources, and to coaching them through their early stage development. VC is therefore an important internal factor in the early stages of a startup. Compared with other forms of investment, a unique feature of venture capital financing is that VC firms often play an ongoing role in helping manage the ventures in which they invest (Steier, 1998). The cooperative arrangements between VC and venture-backed firms should allow VC firms to intervene in various capacities to enhance and protect an entrepreneurial venture. Some of the more common forms of VC support include

1. Acting as a sounding board to a venture-backed company,
2. Serving on a new venture's board of directors,
3. Making customer and supplier introductions,
4. Monitoring operating performance, and
5. Assisting with strategic issues (Timmons & Bygrave, 1986; MacMillan et al., 1987; Fried & Hisrich, 1995).

However, VC firms can also hinder a start-up's growth if they provide the wrong strategic input or impose ill-advised constraints (Steier & Greenwood, 1995; Gomez-Mejia et al., 1990). In addition, VC firms sometimes dismiss team members (Rosenstein et al., 1993), which can be disruptive to a relationship between a VC firm and a venture-backed company (Fiet et al., 1997). The emergence and nurturing of this relationship is made possible by the sharing of knowledge, the access to and combination of critical resources and the shorter time-to-market (Doz & Hamel, 1998).

In assessing the current state of research on VC, we observe that most of the studies are US-centric (see also Berglund, 2011). This means that empirical findings are related to US institutional conditions. This could make it meaningless if not misleading to apply these findings to other geographical and institutional contexts. Moreover, the majority of empirical studies are inspired by a variance approach, which is suitable for identifying statistically significant correlations among variables but is ill suited for capturing how a certain phenomenon evolves over time. This makes it useful to investigate how different institutional contexts and internal conditions interact and affect entrepreneurial ecosystems across the globe and how they co-evolve over time.

For this reason, we believe that it is timely to investigate the role of VC in geographical and institutional contexts other than the US and how the relationship between the Venture Capitalist and the