



**NTNU – Trondheim**  
Norwegian University of  
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# The venture capitalist - entrepreneur relationship

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## **Problem description**

The purpose of this thesis is to gain a better understanding of the Venture capitalist - entrepreneur relationship.

The students will perform a case study analysis of relations between the entrepreneur and investor focused on but not limited to the pre-investment stage. This thesis acknowledge the complexity of the relationship between the venture capitalist and the entrepreneur, investigating factors that affect cooperative behavior.

Assignment given: February 15th, 2013

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## Preface

This master thesis is the work of Marie Jacobsen Lauvås, Sigve Martin Pettersen and Emma Evensen Lie Olsen. The three are students at the Norwegian University of Science and Technology (NTNU) studying a masters program in Entrepreneurship. This thesis is based on research conducted in the period February-July 2013.

Two of the authors were at point of writing this thesis entrepreneurs working on a daily basis in their own startups. The background for this thesis was to examine a problem the entrepreneurs themselves have experienced as difficult; the process of obtaining external financing and the challenges linked to acquiring and maintaining good relations to investors. The experience and contact the entrepreneurs have had with other entrepreneurs at the NTNUs school of entrepreneurship, meetings with experienced investors, boards of directors and the inspiration from other Norwegian serial entrepreneurs is what inspired us to do research on the topic and helped us form the research questions within this thesis.

We wish to thank our two thesis supervisors, Professor Roger Sørheim at the NTNU Entrepreneurship Center and Elsebeth Holmen at the NTNUs Department of Industrial Economics and Technology Management, for the invaluable support, motivation and feedback given. Roger Sørheim's competence and insight from previous research have helped us gain a greater understanding of the early phase investment period in entrepreneurial firms and the revision by Elsebeth Holmen have helped us create a detailed analysis of the literature inspired by her academic joy, extensive knowledge and structure. Our supervisors have both given us constructive guidance and encouragement along the way.

The hypothesis proposed in this thesis need to be examined further, but we hope that our finding will contribute to a greater understanding of the VC-entrepreneur relationship and how it develops. Especially, we wish that our thesis will give the entrepreneurs a greater understanding of how they can use the results in this thesis to evaluate their own investor readiness, screen for the right investor and use their resources strategically to obtain a best possible relationship to potential investors.

  
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## Abstract

In this master thesis we have performed an explorative study on the VC-entrepreneur relationship.

**Paper 1** is a literature review of several frameworks describing the VC-entrepreneur relationship, how these frameworks take the VC and/or the entrepreneur's perspective, and their applicability and limitations to the pre- and post-investment stage. Our main findings in this literature review show that little emphasis has been placed on the pre-investment stage and how the VC-entrepreneur relationship is initiated and developed. In addition few scholars take a demand-side view on equity finance which leads to an unbalanced understanding of the forces affecting the market for venture capital. Two main findings from Paper 1 was that social embeddedness may help explain how external parties in the entrepreneur's network may mediate the relation to investors and there is a need to further investigate how the entrepreneur may initiate and build relationships towards investors in an early venture stage. Thus the following papers aim to explore these findings.

**Paper 2** investigates how outside directors may strengthen entrepreneurial ventures in an early stage by performing explorative case analyses. Our findings suggest that outside directors may strengthen high-growth entrepreneurial ventures in an early stage by increasing the ventures competitive advantage in terms of strategically combining and managing resources. In addition they add legitimacy towards external stakeholders and increases the ventures interaction with its surroundings. The implications from Paper 2 suggest that more qualitative research should be performed on how the outside directors' strengthening contribution to early stage ventures can be related to stage theory.

**Paper 3** explores how entrepreneurs may develop investment readiness to bridge the financing gap and become seed level investor ready. This was done by conducting an explorative, theory building case study. From exploring the investment readiness we build a model that are able to relate investment readiness to the stages of development, and offers an explanation to how entrepreneurs use social ties as an information transferring mechanism effectively developing the investment readiness of the venture in order to overcome the high level of information asymmetry and risk related to the early stages of venture development. The implications from paper 3 suggest that the use of social ties could improve the entrepreneurs ability to become seed stage investor ready and effectively bridge the gap in early stage venture capital.

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## Sammendrag

Denne masteroppgaven ser på VC-entreprenør forholdet gjennom utforskende case studier.

**Artikkel 1** er en litteraturgjennomgang av flere rammeverk som beskriver VC-entreprenør forholdet, hvordan disse rammeverkene tar et VC- og/eller et entreprenørperspektiv, og deres anvendbarhet og begrensninger til pre-og post-investeringfasen. Litteraturgjennomgangen tyder på at få rammeverk som beskriver VC-entreprenørrelasjonen fokuserer på pre-investeringfasen og hvordan VC-entreprenørforholdet initieres og utvikles. I tillegg viser litteraturgjennomgangen at få rammeverk tar entreprenørens synspunkt, noe som fører til en ubalansert forståelse av hvilke krefter som påvirker markedet for risikovillig kapital. To hovedfunn fra Artikkel 1 er at sosial nettverksteori kan bidra til å forklare hvordan eksterne parter i entreprenørens nettverk kan megle forholdet til investorer, og det samtidig et behov for å undersøke nærmere hvordan entreprenøren kan starte og bygge relasjoner opp mot investorer i en tidlig fase. Artikkel 2 og 3 tar derfor sikte på å utforske disse funnene.

**Artikkel 2** undersøker hvordan eksterne styremedlemmer kan styrke entreprenørbedrifter i en tidlig fase ved å utføre utforskende case studier. Funnene fra Artikkel 2 tyder på at eksterne styremedlemmer kan styrke vekstbedrifter i en tidlig fase ved å øke bedriftenes konkurransefortrinn i form av å strategisk kombinere og administrere ressurser. I tillegg kan eksterne styremedlemmer gi legitimitet overfor eksterne interessenter og samtidig øke bedriftens interaksjon med omgivelsene. Implikasjonene fra Artikkel 2 tyder på at mer kvalitativ forskning bør utføres på hvordan eksterne styremedlemmer kan styrke entreprenørbedrifter i tidlig fase ved å se på teori som forklarer hvordan bedrifter utvikler seg gjennom forskjellige faser.

**Artikkel 3** utforsker hvordan entreprenøren kan utvikle seg til å bli nok investeringsklar til å få investering i tidlig fase. Dette ble gjort ved å gjennomføre utforskende, teoribyggende case studier. Fra å utforske hvordan entreprenører kan utvikle seg til å bli investeringsklare så bygger vi en modell som er i stand til å relatere investeringsklarhet til utviklingsstadier, og tilbyr en forklaring på hvordan entreprenører kan bruke sosiale relasjoner som en mekanisme for informasjonsoverføring som effektivt utvikler investeringsklarheten til selskapet for å unngå høy grad av informasjonsasymmetri og risiko knyttet til de tidlige stadiene av bedriftsutviklingen. Implikasjonene fra Artikkel 3 tyder på at bruk av sosiale relasjoner kan forbedre entreprenørens mulighet til å bli investorklar i såkornstadiet og effektivt bygge bro over gapet til tidlig stadium venture kapital.



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## 1. INTRODUCTION

Ventures at an early stage are often resource constrained, which leads to a high probability of failure in the early venture stage. As suggested by Kaiser et al. [2007] young companies often suffer from the so-called 'liability of newness'. Entrepreneurs need to obtain financing, necessary know-how and industry expertise, which they do not necessarily possess themselves. Because the future cash flow is uncertain and because the ventures have few assets to serve as collateral, many ventures cannot obtain bank loan financing [Kaiser et al., 2007], thus investor financing becomes an alternative. An equity investment refers to the buying and holding of shares of a stock from firms or individuals with the anticipation that the value of the stock will rise [BusinessDictionary]. Venture capital (VC) could be an important source of finance in the early stage of a venture since VCs devote significant management resources to understand new technologies and markets. They search for new promising ventures and provide them with financial resources and coaching through the early part of their lives [Davila et al., 2003]. Therefore Timmons and Bygrave (1986, as cited in Zacharakis et al. [2010]) suggest that the cooperative relationship between the VC and entrepreneur could be more important to the success of the venture than the capital itself.

In order to give the reader a sufficient contextual background for the three papers we will first give a general introduction to the phenomenon of the VC-entrepreneur relationship. Thereafter we will move on to argue why a cooperative relationship between the VC and the entrepreneur is important at a very early stage by highlighting elements from the investment process and the so called 'liability of newness'. The next section will give an overall reflection on the methodologies applied in this research project followed by summaries of the aims and main findings in each paper. Finally, we offer a conclusion to the three papers and give the overall implications of this thesis.

The reader's emphasis should be on the three papers appended. Paper 1 gives a thorough literature comparison of the application and limitation of several VC-entrepreneur relationship framework's ability to describe areas in the pre- and post-investment stage and from the VC and/or the entrepreneur's perspective. Further, paper 2 gives an explorative multi-case analysis of how outside directors may strengthen high-growth entrepreneurial firms at an early stage by adding resources, legitimacy and monitoring and control. Finally, paper 3 gives an explorative multi-case analysis of how entrepreneurs may develop investment readiness to bridge the financing gap and become seed level investor ready.

### **An introduction to the VC-entrepreneur relationship**

The advantage of having investors on board may be a huge benefit for entrepreneurial ventures [De Clercq et al., 2006] in terms of getting access to finance and other value adding resources. However, according to Shepherd and Zacharakis [2001] the potential is contingent upon being able to establish an open and trustfull relationship. Securing a good relationship implies finding the *right* investor, where a foundation for a good match are contingent on complementary skills, commitment and a potential for an open and trustfull relationship [De Clercq et al., 2006].

The VC-entrepreneur relationship has been depicted in many different perspectives. Several scholars have tried to model the VC-entrepreneur dyad in established relationships in order to explain antecedents and processes leading up to certain behaviors, but most of them differ in their approach to the phenomenon and try to explain different aspects of the VC-entrepreneur relationship. VCs may offer the entrepreneurs the resources they need in terms of finance, advice

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and industry expertise, but little is known about how the initial relationships between the VC and the entrepreneur develop and there is little theory explaining the phenomenon in an early venture stage.

One premise in most theories concerning the VC-entrepreneur relationship is the uncertainty and information asymmetry governing the relationship between the VC and the entrepreneur (Cumming and Johan [2008]; Davila et al. [2003]; Eisenhardt [1989b]). As the information asymmetry is socially complex, tacit and path dependent it would be practically impossible to remove it completely. Even if the entrepreneur and investor both recognized the same value of the opportunity, they might differ in the confidence and cognitive perception of the entrepreneurs ability to exploit the opportunity in the most profitable way [Lahti, 2012]. Interactions are argued to have a cumulative affect on the relationship [Ford et al., 2010], thus the effect of sharing a longer joint history might decrease this asymmetry. Hence, social complex knowledge in terms of culture, reputation, and human capital (Alvarez and Busenitz [2001]) could be shared through social interactions (Granovetter [78]; Sørheim [2003]). This implies that the more specialized the two parties are, and the less shared history they have, the harder it would be for the entrepreneur to get external funding. However, as the venture matures the information asymmetry is thought to reduce as a function of increased reputation, track record, and the information and knowledge becomes more explicit as it is developed with explicit proof of technology and market (De Clercq et al. [2006]; Lahti [2012]). Thus the information asymmetry between the entrepreneur and investor could be related to the ventures stage of development and since little is known of how the initial relationship between the VC and entrepreneur develops it is interesting to examine how this relationship is depicted in the pre-investment stage.

### **The VC-entrepreneur relationship during the investment process**

In this article we define the pre-investment stage as the point where no investment in turns of money, capital or a quantity of shares of stock has been invested in a business in order to gain profitable results, interest, income or appreciation in value. It is at this stage the entrepreneurs are said to suffer the most from 'the liability of newness' due to high uncertainty [Davila et al., 2003] and since they often lack the necessary resources for the venture to succeed [Brush et al., 2001]. Thus the VCs in this stage seem preoccupied with decreasing this uncertainty as well formulated in the below statement.

"We have a strong belief that the companies ought to have external board members with relevant industry experience within the segments that the company is about to enter. This is because it takes time to get to know specific industries, at least 10 to 20 years until you fully understand how the industry operates and till you have developed a strong network. If you are a company in an early stage founded by young entrepreneurs, then they lack this experience, and we do not support such a high-risk sport ... To us it is a big plus if an entrepreneur has managed to attract some extra strong outside directors because this tells us that the entrepreneur is actively searching for someone they believe has what it takes and who they believe might sit with all the answers. This is an attitude that we highly appreciate". - *Managing partner, VC-company*

In addition to the above statement's acknowledgement of the facilitating role of outside directors, previous studies also suggest that business angels may serve a facilitating role in obtaining venture capital as they may reduce the firms' 'liability of newness' (Madill et al. [2005]; Sørheim

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[2005]). As suggested by Levie and Lichtenstein [2010] growing businesses go through distinguishable stages at different times in their history, and according to the statement below it seems as if the investor divide the relationship in the pre-investment process into the first, where the entrepreneurs are not yet investor ready and, the second, as when the company is ready to seek investments.

“We are very eager to meet a lot of companies although many of them might be in a too early stage for investments, because this is a nice way for us to get to know the team and listen to their plans. Then we can follow them on their way until they mature and become ready for investments”. - *Managing partner, VC-company*

The above statement indicate that VCs are concerned with building relationships to entrepreneurs at a very early stage. Different investors have different preferences in terms financing stage (De Clercq et al. [2006]), and lately there has been wide recognition of a financing gap in the supply of early stage venture capital. This is argued to come as a consequence of information asymmetry (Cable and Shane [1997]) and uncertainty due to unfamiliarity and tacit knowledge (Sørheim et al. [2011]). However, several researchers (e.g. Mason and Kwok [2010] and Mason and Harrison [2001]) argue that this is partly due to entrepreneurs not being able to become investor ready.

## 2. MOTIVATION FOR STUDY

The founding of new high growth businesses is often regarded to be important for both global innovation and economic growth (Schoonhoven and Romanelli [2001]; Shane and Cable [2002]) and innovation is one of Norway’s main priorities [Stortinget, 2013]. However, in the European Scoreboard 2013 Norway is listed as a moderate innovator with a below average performance [Hollanders and Es-Sadki, 2013]. Some of the main observations since 2012 are a strong decline in Venture Capital investments and in Finance and support. Both firm investments and innovators are listed as well below average. Earlier studies have indicated that emergent growth ventures face considerable challenges in the process of acquiring financing in the institutional capital market (Binks and Ennew [1997], Cressy and Olofsson [1997], Osnabrugge [2000], Silver et al. [2010]). Since the Norway Liberal Party recently launched a party program giving entrepreneurs better access to capital [Programkomité, 2013], this indicates that there is a national focus on the problems associated with investments and survival of new ventures. With this in mind our motivation behind the focus of this master thesis is to explore how early stage ventures become investment ready, develop cooperative relationship to investors and acquire scarce resources for success in an early stage.

## 3. METHODOLOGY

This section gives an overview of the research process in this thesis. More academic and detailed discussions on the research design and methods are included in the respective papers.

### **The Point of Departure**

Two of the authors behind this paper are entrepreneurs and thus experience challenges associated with relationship-building processes towards investors, making the problems discussed in this

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master thesis highly relevant. The basis for this master thesis was laid during January 2013 after which two of the authors had just finished individual project thesis with focus on how entrepreneurs build relationships in an early venture stage and the third author behind this master thesis had previously written a project thesis about the investment process from the VC perspective. Because of the problems' relevance to the entrepreneurs, the authors decided to examine the VC-entrepreneur relationship from the entrepreneur's perspective.

## **Literature Screening**

In order to figure out what had previously been written about the VC-entrepreneur relationship the authors conducted a literature screening and analysis spring 2013 in order to examine the phenomenon. Paper one included in this master thesis therefore gives an overview of the applicability and limitations of the VC-entrepreneur relationship frameworks. The first paper have analyzed the frameworks used to model the VC-entrepreneur relationship from the VC's and/or the entrepreneur's perspective and also analyzed how the frameworks complement each other and their applicabilities and limitations to the pre- and post-investment stage. The most striking finding was that there was very little written about how the initial relationship between VCs and entrepreneurs develop and, more interestingly, there was a lack of research on how elements in the period before the entrepreneur and VC first meet influence the relationship. Thus the authors decided to investigate further how outside directors might strengthen entrepreneurial ventures in an early stage and, as mentioned above, how the entrepreneur may develop investment readiness to bridge the financing gap and become seed level investor ready.

## **Research Design**

Since very little was written about the entrepreneur's perspective on the initial development of investment readiness and we found no previous literature on how outside directors might strengthen entrepreneurial ventures at an early stage from the entrepreneur's perspective, we decided to divide these research questions into two separate exploratory multi-case studies. Our goal was to give a better insight to how factors in a very early venture stage might affect the VC-entrepreneur relationship. This was done by exploring how the so-called 'liability of newness' could be decreased by exploring how companies develop investment readiness and how outside directors might strengthen entrepreneurial ventures at a very early stage. In order to explore the phenomenon of investment readiness we decided to enter the process without any biased presumptions and therefore we first performed an inductive study followed by a deductive study, thus paper three is a theory-building article inspired by grounded theory using case studies. Paper two was based on explorative research without any theoretic presumptions, making it a inductive study.

## **Sampling**

Paper 2 and paper 3 had a quite different approach to the phenomenon, thus sampling of cases differed between the two papers.

### **Paper 2**

Based on a strategic sampling of high-growth Norwegian entrepreneurial ventures that had acquired outside directors at an early stage we identified several interesting case companies. We contacted CEOs and outside directors that was already in our network and ended up with three case companies where we conducted interviews with the CEO and an outside director in each

company. The outside director in case company A was the very same person as the outside director in case company B. An overview of the cases included in paper 2 is listed in Table 3.1 below.

**Table 3.1:** *Overview of cases paper 2*

venture	Entrepreneur	Board member	Industry	Status of company
<b>venture A (Paper 2)</b>	CEO A	Outside chief of director A,B	IT/telecom	Expanding market horizon
<b>venture B (Paper 2)</b>	CEO B	Outside chief of director A,B	Consumer	Company sold
<b>venture C (Paper 2)</b>	CEO C	Outside director C	IT/telecom	Company seeking investment

### Paper 3

The sampling of case companies in paper 3 was based on two entrepreneurial ventures in an early stage that the authors knew were seeking for investments and which was located in close proximity to the authors. In addition the authors performed interviews with one pre-seed investor and one local VC. An overview of the cases included in paper 3 is listed in Table 3.2 below.

**Table 3.2:** *Overview of cases paper 3*

venture	Interviewee 1	Interviewee 2	Workshop participants	Industry
<b>Company A</b>	CEO	CFO	CFO	Oil and gas
<b>Company B</b>	CEO	CFO	CEO and CFO	Maritime
<b>Investor</b>	Pre-seed investor (company B)	Local VC investor		

## Interviews and Workshops

During the spring 2013 we conducted a total of 10 interviews and two workshops, 5 interviews in paper 2, and 6 interviews and two workshops in paper 3. In paper 2 we conducted 3 interviews with CEOs and 2 interviews with outside directors since one of the outside directors was the same in both company A and B. In paper 3 we conducted 3 mapping interviews of the case companies and 2 workshops with each company. In addition we conducted two interviews with investors. The interviewees were given a citation check, but no adjustments have been made to the transcriptions. In total these interviews and workshops lasted 9 hours and 12 minutes and all interviews were tape recorded and transcribed. The transcriptions totaled 142 single-spaced pages and nearly 75 000 words.

In paper 2 interview guides were built in order to ensure consistency between interviews as to compare them afterwards. Two separate guides were created, one for the CEOs and one for the outside directors. The interview guides were based on the authors' knowledge from literature

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reviews and can be found in Appendix A. Adjustments to the interview guides were made as the authors conducted the interviews and the informants contributed with new insights to topics. It must be noted that all interviews were conducted in Norwegian and all transcriptions were written in Norwegian. Thus all quotes used in this master thesis have been translated into English by the authors.

## **Data Analysis**

When the empirical data had been collected the transcriptions were coded in order to analyze the content in a within analysis of each case followed by a cross-case analysis between the different cases. This procedure was also followed in the literature review paper and in all three papers this was a highly iterative process where the authors frequently stepped back and fourth between the empirical data and the analysis.

In paper 3 the authors initially performed an inductive study which resulted in some new interesting aspects of how a model of investment readiness would look like. These findings were used to draw a proposed model of investment readiness which was further tested in workshops with the case companies.

## **Limitations**

The cases selected in paper 2 were based on a strategic sampling of high-growth entrepreneurial ventures that had acquired outside directors at an early stage. The different industries, different experiences and backgrounds and paths taken indicate that the study is somehow generalizable. However, the number of cases is too low to to give the analysis statistical representativeness, thus further studies should be conducted to increase knowledge in this area.

In paper three the geographic proximity, experience and background of the entrepreneurs make these cases less generalizable. However, the generalizability is increased by the great variation between the case industries.

## **4. SUMMARY OF APPENDED PAPERS**

This section gives an overview of the main aims and findings in the three appended papers.

### **Paper 1: Applicability and limitations of frameworks describing the VC-entrepreneur relationship**

#### **The aim of the Paper**

The aim of this paper was to perform a literature review in order to explore how the VC-entrepreneur relationship can be built and maintained in the pre- and post-investment stage by examining the following research questions:

- Which existing frameworks are used for modelling the VC-entrepreneur relationship from the VC's and/or the entrepreneur's perspective?
- How do these frameworks complement each other and what are their main areas of applicability and limitations to the pre- and post-investment stage?

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### Summary of Findings

By performing a thorough review of literature describing the VC-entrepreneur relationship from the VC and/or the entrepreneur's perspective the authors have given an overview of the application and limitation of each framework's ability to describe areas in the pre- and post-investment stage and from the VC and the entrepreneur's perspective. The authors found six main frameworks used at describing the VC-entrepreneurial relationship and these could be divided into contractual frameworks and dynamic frameworks. The contractual frameworks are principal-agent theory, stewardship theory and the prisoner's dilemma whereas the dynamic frameworks are the procedural justice theory, social embeddedness theory and the organizational learning theory. Our analysis show that contractual frameworks tend to be based on the VC's perspective and explain the relationship in the post-investment stage while there is a lack of research explaining the early pre-investment stage and a lack of research taking the entrepreneur's perspective. The study suggests that the main limitation of contractual frameworks is that they fail to consider entrepreneur's perspective, the dynamic process and the fact that many concepts are simultaneous and highly interrelated in an on-going relationship. Dynamic relationship frameworks may help explain areas in the pre-investment stage where the contractual frameworks are not applicable, but it must be noted that the frameworks differ in the way they relate to the VC-entrepreneur relationship phenomenon, thus some areas that are highly interrelated may yield a better understanding while others may not.

## Paper 2: Investigating how outside directors may strengthen entrepreneurial ventures in an early stage

### The aim of the Paper

The aim of this paper was to perform an exploratory case study on high growth entrepreneurial ventures in an early stage in order to answer the following research questions:

- How can outside directors add scarce resources to high-growth entrepreneurial ventures in an early stage?
- How can outside directors add the needed legitimacy to high growth entrepreneurial ventures in an early stage?
- How can outside directors help the board in high-growth entrepreneurial ventures to monitor and control the use of resources in an early stage?

Our case study contribute to insights in the use of outside directors, an area where there has been none, or limited, research up till now. Our findings show that the outside directors may contribute to scarce resources by adding *organizational, human* and *social* resources consistent with the resource based view, and also increase the ventures interaction with its surroundings by co-optation and added legitimacy in accordance with the resource dependence view. However, what enables the entrepreneur to take advantage of resources obtained from outside directors seems to depend upon the outside director's ability to convey knowledge into a language the CEO understands. Our findings suggest that the outside directors may add legitimacy by their *reputation, CV, experience and trustworthy relationships* and the legitimating role seemed to be situational and vary with the stage of the company. Outside directors seem to help ventures with their monitoring and control of resources by *strategically combining internal and external resources* and *fostering stewardship behavior* and our findings indicate that the value-adding role of the outside director to these high-growth ventures in the early-stage may depend upon the stage of the company and of the extent of the outside director's activity in the firm.



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### **Paper 3: Exploring how to develop investment readiness to bridge the financing gap and become seed level investor ready**

#### **The aim of the Paper**

The aim of this paper is to develop a more holistic and comprehensive model for investment readiness, contributing with insights from the entrepreneurs perspective. This will be done by conducting an explorative, theory building case study on seeking to answer the following research questions:

- How do entrepreneur's plan and develop investment readiness to become investor ready?
- How do entrepreneurs cope with information asymmetry and uncertainty in the process of becoming investor ready?

The study contribute by providing deeper understanding and a definition to the concept of investment readiness, related to both investor ready and the development stages of the venture. In this we provide a basis for better understanding the demand-side weakness argued to contribute to a failure in the market for early stage venture capital. By utilizing the findings from preliminary mapping interviews of early stage high-tech growth oriented ventures, we were able to build on the concept of investment readiness, and relate in to information asymmetry and uncertainty, by building a preliminary theoretical model that was used to analyze and discuss the companies' status and plan for developing investment readiness into becoming investor ready in workshops with each company. The findings lead to a better understanding how the entrepreneurs use direct and indirect social ties as information transferring mechanisms in order to overcome information asymmetry and the investors perceived uncertainty in the 'investability' of the company in order to become investor ready. Effectively, leading up to a new and empirically derived model for investment readiness. This model is able to capture and explain how the social embedded interactions in the direct, and indirect, ties between the entrepreneur and investors affect the process of becoming investor ready. Findings suggest that the investors perceived uncertainty in seed stage development could be reduced by using social ties to familiarize and build trust. Thus helping the investor make a rational investment decision.

## **5. CONCLUSIONS AND IMPLICATIONS**

In this master thesis we have performed an explorative study on the VC-entrepreneur relationship. To find out what was written about the VC-entrepreneur relationship we first performed a literature review where we looked at several frameworks describing the VC-entrepreneur relationship, how these frameworks take the VC and/or the entrepreneur's perspective, and their applicability and limitations to the pre- and post-investment stage. Our main findings in this literature review show that little emphasis has been placed on the pre-investment stage and how the VC-entrepreneur relationship is initiated and developed. In addition few scholars take a demand-side view on equity finance which leads to an unbalanced understanding of the forces affecting the market for venture capital. Two main findings from Paper 1 was that social embeddedness may help explain how external parties in the entrepreneur's network may mediate the relation to investors and there is a need to further investigate how the entrepreneur may initiate and build relationships towards investors in an early venture stage. Thus the following papers aim to explore these holes in theory. The first by investigating how outside directors may strengthen entrepreneurial ventures in an early stage and, the second, exploring how entrepreneurs may develop investment readiness to bridge the financing gap and become seed level investor ready. Our findings suggest that outside

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directors may strengthen high-growth entrepreneurial ventures in an early stage by increasing the ventures competitive advantage in terms of strategically combining and managing resources. In addition they add legitimacy towards external stakeholders and increases the ventures interaction with its surroundings. The implications from Paper 2 suggest that more qualitative research should be performed on how the outside directors' strengthening contribution to early stage ventures can be related to stage theory. From exploring the investment readiness we build a model that are able to relate investment readiness to the stages of development, and opposes an explanation to how entrepreneurs use social ties as an information transferring mechanism effectively developing the investment readiness of the venture in order to overcome the high level of information asymmetry and risk related to the early stages of venture development. The implications from paper 3 suggest that the use of social ties could improve the entrepreneurs ability to become seed stage investor ready and effectively bridge the gap in early stage venture capital.

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# Applicability and limitations of frameworks describing the VC-entrepreneur relationship

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## Abstract

*This article acknowledges the importance of cooperative relationship between the entrepreneur and venture capitalist. Contractual frameworks have sought to structure the relationship by describing the antecedents, content and consequences from a VC perspective. This study suggests that the main limitation of contractual frameworks is that they fail to consider entrepreneur's perspective, the dynamic process and the fact that many concepts are simultaneous and highly interrelated in an on-going relationship. This paper suggests that dynamic relationship frameworks may add to contractual relationship frameworks by explaining process elements causing behaviors. These dynamic relationship frameworks may help the entrepreneur understand how to build a good relationship to an investor in an early investment phase. However, the frameworks differ in the way they relate to the VC-entrepreneur relationship phenomenon, thus some areas that are highly interrelated may yield a better understanding while others may not. Our analysis show that contractual frameworks explain the relationship in the post-investment stage, but there is a lack of research explaining the early pre-investment stage and a lack of research taking the entrepreneur's perspective. Further this paper puts forward that the dyadic VC-entrepreneur relationship is embedded in a wider business network, affected by inter- and intra-organizational relationships, and that network effects may play a significant role in explaining aspects of trust, cooperation and commitment in the VC-Entrepreneur dyad.*

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## 1. INTRODUCTION

Entrepreneurs typically start their venture with passion for an innovative idea and with the anticipation that the firm will become a long-term success, the venture progresses through the initial start-up phase, investments are often sought [Arthurs and Busenitz, 2003]. In addition to financing, entrepreneurs also need the necessary know-how and industry expertise, which they do not necessarily possess themselves. Because the future cash flow is uncertain and the ventures have few assets to serve as collateral, many ventures cannot obtain bank loan financing [Kaiser et al., 2007], thus investor financing becomes an alternative. Investors may offer the entrepreneurs the resources they need in terms of finance, advice and industry expertise. Unfortunately earlier studies have indicated that emergent growth ventures face considerable challenges in the process of acquiring financing in the institutional capital market (Binks and Ennew [1997], Cressy and Olofsson [1997], Osnabrugge [2000]). Because of the uncertain environment of entrepreneurial firms, conflict within the investor-entrepreneur dyad is expected (Landström [2004], as cited in Zacharakis et al. [2010]), but conflict is not necessarily negative as it may improve the decision quality as better alternatives may develop when people are being challenged [Zacharakis et al., 2010]. On the other hand it may also damage consensus and lead to decreased confidence in partner cooperation [Zacharakis et al., 2010], something that might be detrimental to venture success.

The institutional capital market consists of both venture capital (VC) and angel capital (BA). According to Osnabrugge [2000] the Venture Capitalists (VCs) take longer to invest and spend more time in the early phase to build a relationship with the entrepreneur than Business Angels (BAs). Osnabrugge [2000] also posits that VCs tend to document their investment process more, take more independent references on the entrepreneur

and consult more people before investment. Thus VCs are more rule-based than business angels and more concerned with reducing these risks in the pre-investment process as a means of signaling competence to their fund providers [Osnabrugge, 2000]. Most literature examining the ongoing VC-entrepreneur relationship have examined the VC-entrepreneur relationship from a VC perspective with a focus on antecedents and consequences in the post-investment stage, but little is known about how the initial relationships between entrepreneurs and investors develop and little is known about the entrepreneur's perspective on the investment process. However, since the entrepreneur's challenge lies in the process of obtaining external financing initially (Binks and Ennew [1997], Cressy and Olofsson [1997], Osnabrugge [2000]), there is also a need to consider how the VC-entrepreneur relationship is built and maintained in the pre-investment phase. The comprehensive screening and relationship building among VCs and entrepreneurs in the pre-investment phase makes it very interesting to look at the dyadic relationship, and according to Timmons and Bygrave [1986, as cited in Zacharakis et al. [2010]], the cooperative relationship between the VC and entrepreneur is more important to the success of the venture than the capital itself.

Since the cooperative relationship between the VC and entrepreneur is said to be more important to the success of the venture than the money itself (Timmons and Bygrave [1986, as cited in Zacharakis et al. [2010]), this article aim to explore how the VC-entrepreneur relationship can be built and maintained in the pre- and post-investment stage. The research questions are: *which existing frameworks are used for modelling the VC-entrepreneur relationship from the VC's and/or the entrepreneur's perspective? How do they complement each other and what are their main areas of applicability and limitations to the pre- and post-investment stage?*

In this article we present a literature review of the relationship between the entrepreneur

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and the VC. First we present and compare the existing frameworks, contractual and relational, and their contributions and limitations in describing the VC-entrepreneur relationship. The contractual models include *principal agency theory*, *stewardship theory* and *the prisoners dilemma*. The dynamic relationship frameworks presented are the *procedural justice theory*, the *social embeddedness theory* and the *organizational learning theory*. Lastly, the theoretical gaps in explaining the VC-entrepreneur relationship are discussed and directions for further research are offered. In viewing the shortcomings of the existing frameworks explaining the VC-entrepreneur relationship, the attention is focused on how these theories tend to look at the goals and motivations of the entrepreneur and to what extent the frameworks are limited by the type of relationship being examined.

### 1.1 Research method: Literature review

In order to compare and analyze existing frameworks describing the VC-entrepreneur relationship, an initial literature screening was conducted. The authors' initial presumption was that research done within this area was insufficient when looking upon the pre-investment stage. This presumption was based on the existing theory's main focus on relationship-maintenance in the post-investment stage, thus the purpose of the literature screening was to find literature concerned with the following research areas: VC-entrepreneur relations in the pre- and post-investment stage, ongoing processes in the VC-entrepreneur relationship and the entrepreneur's view on relationship-building in an early pre-investment phase. In advance of this study the authors possessed some relevant literature from former papers written in the Innovation and Entrepreneurship, Specialization project (TIØ4530). In addition the authors were guided towards some relevant literature by supervisor Roger Sørheim.

In order to minimize bias the authors initially performed an iterative screening process where results were based on individual search results from each author's chosen search queries and databases, presuming three independent authors would differ in heuristics and thus end up with different results. After a process of interposition a set of the most effective search queries were chosen. However, the authors may have been biased in their choice of key words due to mutual agreement in discussions, their shared contextual environment and former entrepreneurial experience. The combination of search queries was conclusive in what gave the most relevant results in the databases, but it must be said that there could be other combinations of key words that could yield the same result. The most relevant search queries turned out to be: "pre-investment", "investor", "entrepreneur", "relationship", "start-up" and "VC".

The combination of the search queries "entrepreneur", "investor" and "relationship" gave 64800 search results, mostly non-relevant. By exchanging "investor" with "VC" we narrowed the search down to 18100 results, but most of these articles discussed the relationship from a post-investment view. "Entrepreneur", "investor", "relationship" and "pre-investment" gave 1200 search results and by exchanging "investor" with "VC" one more time, the combination "pre-investment", "entrepreneur", "VC" and "relationship", with 679 search results, yielded out to be the most effective combination of search queries in order of relevant results. This set of articles was further screened and narrowed down to the 40 most relevant articles for the review reported in this paper. The relevant literature was chosen based on the frequency of citations, date of publication and coherence with the most relevant key words: *pre-investment*, *entrepreneur*, *VC* and *relationship*. The most relevant articles were the ones that discussed frameworks describing the VC-entrepreneur relationship, compared different frameworks or discussed the entrepreneur or VC's view of the relationship process in

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the pre- or post-investment stage. Although “post-investment” was not one of the initial key words, the combination of key words yielded several articles with focus on and comparisons in the post-investment stage, which supports the authors’ presumption that little is written about the VC-entrepreneur relationship in the pre-investment phase.

The most used databases were JSTOR, Science Direct, Harvard Business Review and Sage Journals, and the most frequent journals were *The Academy of Management Review*, *Entrepreneurship Theory and Practise* and journals in entrepreneurship and finance. The search databases were chosen based on their academic and credible literature within business and management. In addition to search queries a literature comparison and preliminary analysis was done.

## 2. COMPARISON OF CONTRACTUAL FRAMEWORKS DESCRIBING THE VC-ENTREPRENEUR RELATIONSHIP

The VC-Entrepreneur relationship has been studied using many different theoretical views. The majority of the research has taken the VC perspective and used the traditional agency theory approach, focusing on how the VC could control their portfolio of firms and hence secure their investment (Shepherd and Zacharakis [2001], Sapienza and Korsgaard [1996]). However, this theoretical approach has been criticized in many ways for not being able to explain the complexity of the interaction that gives rise to the dyadic relation in focus. The added value from a VC goes beyond financial capital [Kaiser et al., 2007] and the VC-entrepreneur relationship has a significant impact on the performance of the venture [Shepherd and Zacharakis, 2001]. According to Ehrlich et al. [1994], from an entrepreneur’s perspective a VC may provide a wide array of benefits to the venture, such as involvement in operations, networking and operational expertise, management and personnel recruitment, or financial and strategic management. Ehrlich

et al. [1994] posits that these skills constitute a set of value-adding benefits that may evolve through interactions between entrepreneurs and their VCs. A number of studies suggest that co-operative relationships between venture capitalists (VCs) and entrepreneurs are necessary for the success of VC backed ventures (Arthurs and Busenitz [2003], Sapienza and Korsgaard [1996], Cable and Shane [1997]). In order to include the entrepreneur’s perspective, we therefore sought literature that explains the VC-entrepreneur relationship in the pre- and post-investment period from an entrepreneur’s perspective in addition to the relevant articles giving the VC point of view. In this section of the paper we identify the similarities and differences between the contractual frameworks describing the VC-entrepreneur relationship. The frameworks are presented below with emphasis on their areas of application and limitations.

### 2.1 Principal - agent theory

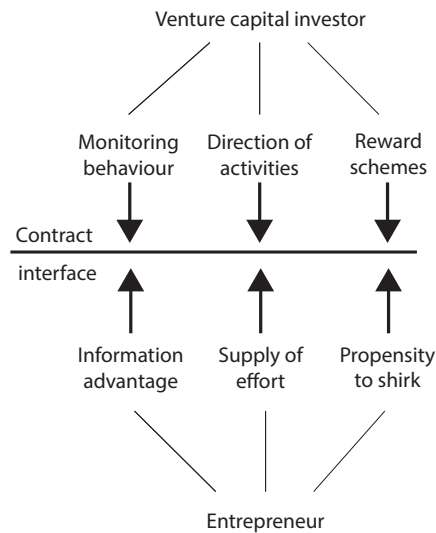
In an attempt to partly describe the relation between entrepreneurs and VC firms in financial contracting, some researchers has used principal- agent theory as a theoretical framework for their research (Gompers [1995] and Kaplan and Stromberg [2001]). “An agency relationship has arisen between two (or more) parties when one, designated as the agent, acts for, on behalf of, or as a representative for the other, designated as the principal, in a particular domain of decision problems” (Ross [1973], p. 134). In the VC-entrepreneur relationship it is normal to view the VC as the principal, and thus the entrepreneur as the contracting agent (Gompers, 1995). The VC firm is not given any private benefits of control, and the entrepreneur receives non-pecuniary benefits from building an independent company (Gompers, 1995 and Kaplan and Stromberg [2001]). Because the VC cannot directly monitor the intensity of the entrepreneur’s efforts, the relationship is influenced by asymmetrical information, e.g. the entrepreneur is more knowledgeable about the business than the VC.



Consequently, two problems may arise: (1) adverse selection, and (2) moral hazard [Kaiser et al., 2007].

Adverse selection occurs because of asymmetrical information [Kaiser et al., 2007]. For example, in the relationship between the VC and the entrepreneur, the VC cannot obtain the same information as the entrepreneur without entering into a binding agreement with the entrepreneur. Moral hazard is related to adverse selection and occurs because of difficulties in observing the entrepreneur's effort. Thus the VC cannot be sure that the entrepreneur is serving in the best possible manner, and the entrepreneur may derive personal benefits from actions that are unknown to the VC [Kaiser et al., 2007]. These may adversely affect the VC and the shared pay-off (Pratt and Arrow [1991], as cited in Kaiser et al. [2007]). The VC can be compared to an outside stakeholder who carefully observes the firm to track its business potential and monitor the entrepreneur's behavior to protect against opportunism [Arthurs and Busenitz, 2003].

In order for the VC to mitigate this conflict researchers has, through principal-agent theory, been able to identify three main solutions; through the structuring of financial contracts, through pre-investment deal screening, and through post-investment monitoring and advising [Kaplan and Stromberg, 2001]. 2.1 shows the setting of the principal agent theory. Figure 2.1 depicts the agency relationship in venture capital finance and identifies three major links: (a) the VC uses monitoring behavior in an attempt to overcome the entrepreneur's information advantage, (b) the VC attempts to guide the direction of the entrepreneur's actions, and (c) the VC constructs a reward scheme to combat any tendency on the part of the entrepreneur to fail to live up to his or her responsibilities [Kaiser et al., 2007].



**Figure 2.1:** *The principal agent setting: the venture capitalist and the entrepreneur. Source: Reid and Smith [2003]*

The use of these methods as mitigation tools has been confirmed by empirical studies. Kaplan and Stromberg [2001] showed that the VC firms allow separately allocating cash flow rights, liquidation rights, voting rights, among other control rights as an instrumental part of their financings. Furthermore, several researchers have identified the extensive use of deal screening in the pre-investment phase (Clercq et al. [2006]; Fried and Hisrich [1994]; Tyebjee and Bruno [1984]). Finally, it has also been confirmed that the VC plays an active role in the post-investment monitoring and advising, often by taking a seat on the board (Kaplan and Stromberg [2003]; Sahlman [1990]; Smith [2005]; Williams et al. [2006]), or by staging the invested capital (Gompers [1995]; Sahlman [1990]; Schwienbacher [2005]).

While agency theory is able to describe a good part of the VC-entrepreneur relationship, it has also been criticized for several shortcomings. Shepherd and Zacharakis [2001] criticize the application of agency theory for *only describing the VC-entrepreneur relationship from the VC's perspective*. The research using agency theory focuses on the entrepreneur's ability to act opportunistically, and thus fails to take the en-

trepreneurs view on the relationship and fail to consider that the VC may also act opportunistically for example in terms of shirking [Gifford, 1997], and perhaps more important with regards to exit decisions (Gompers [1996]; Neus and Walz [2005]). Arthurs and Busenitz [2003] add another important critique to the use of agency theory by indicating that *the agency problem is not uniform throughout the life of the venture*, and suggests some boundaries to agency theory as shown in Figure 2.2. Another critique to agency theory is the research method used by many scholars. Most agency problem literature relies on normative assumptions claiming

that the agency problem exists as a phenomena and therefore focus on how the problem can be overcome (Kaplan and Stromberg [2001]; Terjesen et al. [2012]). Such an ontological point of departure is able to explain why a principal-agency relationship occurs instead of asking how different external factors and individual behaviors might influence the VC-entrepreneur relationship. Arthurs and Busenitz [2003] have used agency theory to focus on how the VC-entrepreneur relationship develops as shown in Figure 2.2 (Zacharakis et al. [2010]; Hernandez [2012]).

*Perceived goals between the VC and Entrepreneur*

		Same	Different
<i>Actual goals between the VC and entrepreneur.</i>	Same	<b><i>No agency problem</i></b> Agency theory prescribes behaviour for the principal to get to this quadrant. Once in this quadrant, agency theory's normative assumptions are (for the time) not able to explain behaviours.	<b><i>Perceived agency problem</i></b> Extensive contracts are needlessly assembled because the VC believes there is an agency problem. However, agency theory's normative assumptions are (for the time) much less applicable.
	Different	<b><i>Hidden agency problem</i></b> Agency theory explains the agent's behaviour and prescribes the mechanisms for the principal to avoid this quadrant. Agency theory's normative assumptions are able to explain behaviours.	<b><i>Visible agency problem</i></b> Agency theory explains the behaviour of the principal and the agent. The normative assumptions of agency theory are able to explain behaviours.

**Figure 2.2:** Goal congruence/noncongruence and perceived congruence/noncongruence between the VC and entrepreneur. Source: Arthurs and Busenitz [2003]

In Figure 2.2 a distinction is made between the perceived goals and the actual goals between the entrepreneur and investor. The variation in goal congruence/noncongruence may differ in time and space, where space is the context of the VC-entrepreneur relationship, and Arthurs and Busenitz [2003] makes it clear that *a specification and boundary of theory in time and space is important in order to avoid the identification of false relationships or non-significance*

*in true relationships*. According to Arthurs and Busenitz [2003] the actual and perceived goals of the entrepreneur and investor are most likely to differ immediately prior to the VC's investment, thus agency theory would be most useful in the immediate pre-investment stage. However, when the investment is made the agency concerns rapidly decline due to goal congruence between the entrepreneur and VC, later followed by potential upswings [Arthurs

and Busenitz, 2003]. The upper left quadrant in Figure 2.2 shows goal alignment between the entrepreneur and VC and in this case there is no agency problem (Eisenhardt [1989b], as cited in Arthurs and Busenitz [2003]). Agency theory gives a framework for the VC to achieve goal alignment with the entrepreneur in order to protect the VC against or mitigate the agency problem (Bohren (1998); Eisenhardt [1989b]; Jensen (1983), as cited in Arthurs and Busenitz [2003]), which means that agency theory attempts to move the VC-entrepreneur relationship into the upper left quadrant of Figure 2.2 where there is no agency problem [Arthurs and Busenitz, 2003]). The theory is also limited in explaining the upper right quadrant in Figure 2.2, which Arthurs and Busenitz [2003] calls the “blind spot for agency theory” because in this case the goals of the VC and entrepreneur are the same, but the VC perceives them as different. But in this situation there is no agency problem which, in turn, mitigates the relationship into the upper left quadrant. The only two quadrants that agency theory actually can explain are the two bottom ones, because these are the two quadrants where there is goal misalignment between the two parties.

Agency theory’s normative assumption is that the VC should invest in monitoring of the entrepreneur in order to avoid or uncover any agency problems, which will move the relationship to the upper left quadrant in Figure 2.2 where there is no agency problem. As several researchers have observed the extensive use of deal screening in the pre-investment phase (Clercq et al. [2006]; Fried and Hisrich [1994]; Tyebjee and Bruno [1984]), this enables the VC to evaluate and monitor the entrepreneur before employment and therefore the agency problem can to a great extent be mitigated in the pre-investment stage [Williamson, 1988]. A priori to investment there is information asymmetry between the VC and the entrepreneur. The VC does not know the entrepreneur’s motivation or implementation capacity and

must assume the worst in order to protect the investment, so the main motivation of the VC may to begin with be to screen the entrepreneur through proper due diligence. On the other hand the entrepreneur does not know the VC and most likely aim for venture success. Thus there might be goal misalignment in the pre-investment phase giving rise to potential agency problems [Arthurs and Busenitz, 2003]. However, when the investment is made the goal of the VC becomes venture success leading to goal congruence between the VC and entrepreneur. Again *this mitigates the relationship to the upper left quadrant in Figure 2.2, where agency theory is no longer is applicable*. Table 2.1 shows the limitations of the principal-agent theory in explaining the VC and entrepreneur perspective in the pre- and post-investment stage. So far agency theory has been a prescription for principals to minimize their agency costs in the pre- and post-investment stage related to the agent’s self-serving behavior by imposing internal controls [Davis et al., 1997]. Thus there is only focus on the VC’s perspective and the theory fails to take the entrepreneur into perspective.

**Table 2.1:** *Limitations to the principal-agent literature in describing the pre- and post-investment stage from both the entrepreneur and the VC’s point of view.*

	Pre-investment	Post-investment	Both
VC’s perspective	X	X	X
Entrepreneur’s perspective	0	0	0
Both	0	0	0

\*‘Both’ indicates that the two keywords have been described together in the same article. X = Keyword described in framework, 0 = No explanation of keyword in framework.

With these theoretical and empirical limitations in mind, a new alternative view of managerial motivation, namely the stewardship theory, has been introduced in order to provide better explanation of the VC-entrepreneur relationship [Davis et al., 1997].

## 2.2 Stewardship theory

In contrast to agency theory, stewardship theory is based on elements from sociology and psychology and offers an alternative view in which organizational actors see greater long-term profit in other-focused, prosocial behavior rather than the self-serving and short-term opportunistic behavior described in agency theory [Hernandez, 2012]. Thus, stewardship theory is to a greater extent able to describe the relationship in the post-investment phase where the goals of the VC and entrepreneur are aligned. While agency theory models the

VC and entrepreneur as self-interested actors rationally maximizing their own personal economic gains, this model presumes the notion of an in-built conflict of interest between the VC and entrepreneur [Davis et al., 1997]. Hernandez [2012] defines stewardship as “the extent to which an individual willingly subjugates his or her personal interests to act in protection of others’ long-term welfare” [Hernandez [2012], p. 8], and describes the relationship as a covenantal relationship in which a moral commitment binds both parties to work toward a common goal without taking advantage of each other. In this model the entrepreneur essentially wants to do a good job, thus being a good steward of the corporate assets [Davis et al., 1997].

Hernandez [2012] has created a model of the suggested antecedents that drive stewardship behavior as shown in Figure 2.1.

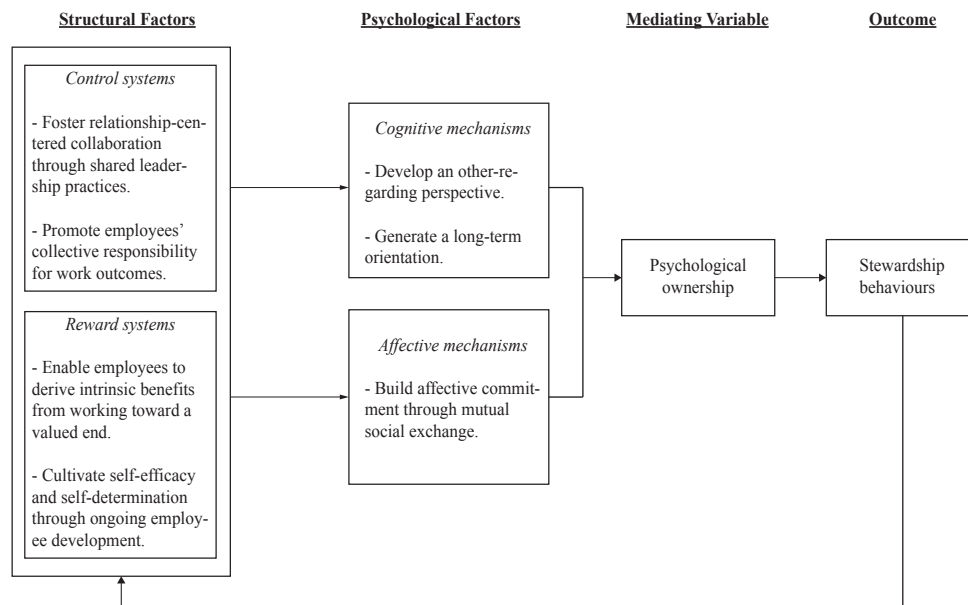


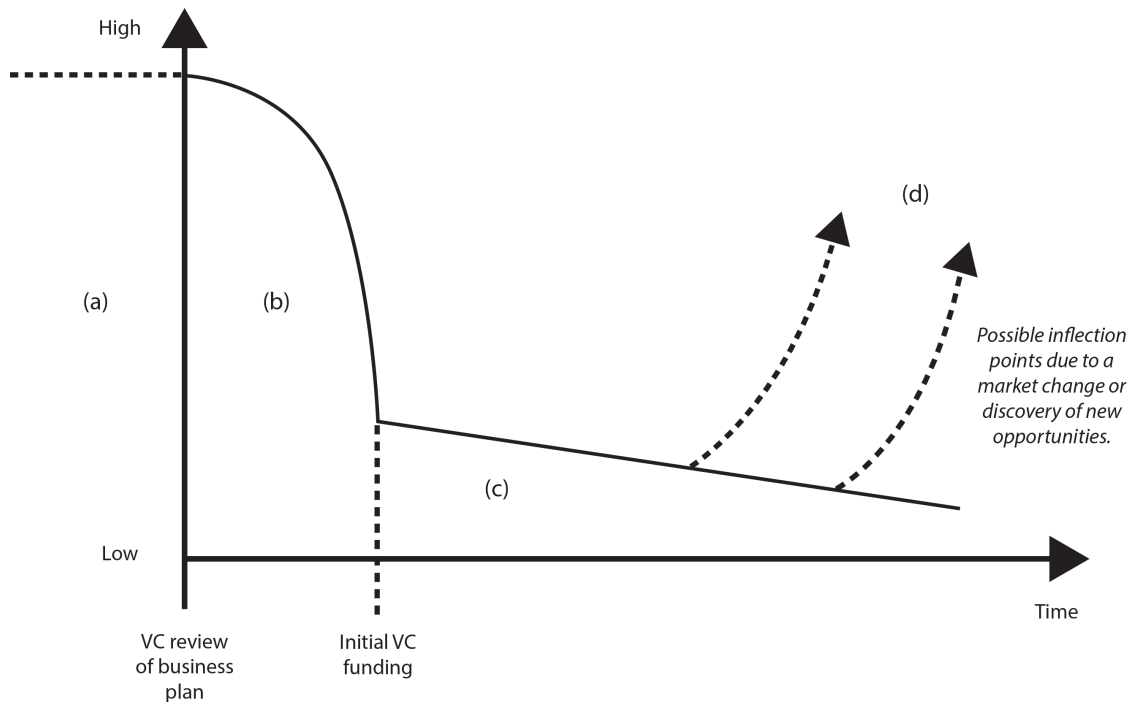
Figure 2.3: A model of stewardship antecedents. Source: Hernandez [2012]

This model posits that the cognitive and affective variables that drive stewardship behavior are affected by the structural factors of stewardship governance. The stewardship theory posits that there is no inherent, general problem of executive motivation among entrepreneurs [Davis et al., 1997], thus the question is how far entrepreneurs can achieve the good corporate performance. In such a covenantal relationship both the VC and the entrepreneur recognize their fiduciary obligations to protect the interests of stakeholders and the entrepreneur also believes he is morally obliged to pursue these interests [Caldwell et al. [2002], as cited in Hernandez [2012]].

While principal-agency theory assumes there is a clear separation of interests between entrepreneurs and VCs at the objective level, Silverman [1970] argues that organizational sociologists would point out that what motivates individual calculative action by entrepreneurs

is their personal perception and not financial gain (Silverman [1970], as cited in Davis et al. [1997]).

Arthurs and Busenitz [2003] suggest that the likelihood of an agency problem may vary with time and the discovery of new opportunities as shown in Figure 3.6. Thus, Arthurs and Busenitz [2003] suggest that the VC may overcome potential agency problems already in the pre-screening, pre-investment process and that goal congruence between the entrepreneur and VC is likely to take place the day the VC chooses to invest, thus the probability of an agency problem is smallest in the post-investment stage. Thus Arthurs and Busenitz [2003] propose stewardship as a more applicable model to picture the VC-entrepreneur relationship in this stage where there is assumed goal congruence.



**Figure 2.4:** Goal misalignment between the VC and entrepreneur over time. Built on the Agency Model drawn by Arthurs and Busenitz [2003]. (a) = period before first encounter between the VC and entrepreneur, (b) = pre-investment screening process, (c) = the post-investment period and (d) = possible inflection points leading to goal misalignment.

According to Etzioni (1975, as cited in Douglas and Sheapher [2002]) a manager may calculate a course of action as unrewarding personally, but still carry it out from a sense of duty. Douglas and Sheapher [2002] suggests that to the degree that executives feel their future fortunes are bound to their current corporate employers through an expectation of future employment or pension rights, then the individual executive may perceive their interest as aligned with that of the corporation and its owners, even in the absence of any shareholding by that executive [Douglas and Sheapher, 2002]. While agency theory suggests that shareholder interests will be safeguarded only when the chair of the board is not held by the CEO or when the CEO and shareholders have the same interests through an appropriately designed compensation plan, this excludes one critical factor for shareholder returns, namely a correctly designed organization structure which allows the CEO to take effective action [Williamson, 1985]. Stewardship theory, in contrast to agency theory, defines the VC-entrepreneur relationship based upon other behavioral premises [Davis et al., 1997]. The theory describes entrepreneurs as stewards whose motives are aligned with the objectives of their principals.

Furthermore, *research on stewardship theory has naturally taken the VC perspective* since it originally is derived from principal-agent theory, thus there is a need to further explore how the stewardship phenomena evolves from the entrepreneur's perspective. Stewardship theory describes a condition in which the goals of the entrepreneur and the VC are aligned and *has so far only been applied to the post-investment stage*. Table 2.2 shows the limitations of stewardship theory in describing the VC/entrepreneur perspective in the pre- and post-investment stage. Previous literature has focused on how stewardship theory differs from agency theory rather than exploring a deeper understanding of the stewardship construct and why it evolves [Davis et al., 1997].

**Table 2.2:** *How stewardship theory has been described in literature in the pre- and post-investment stage from both the entrepreneur and the VC's point of view.*

	Pre-investment	Post-investment	Both
VC's perspective	0	X	0
Entrepreneur's perspective	0	0	0
Both	0	0	0

\*'Both' indicates that the two keywords have been described together in the same article. X = Keyword described in framework, x = Keyword described in framework to some extent, 0 = No explanation of keyword in framework.

Except from Hernandez [2012] there has been little theoretical development of the psychological dynamics that give rise to stewardship behaviour and there is a need to further explore the antecedents that facilitate dynamics of the agency problem, empirical knowledge of how stewardship is created is to a great extent absent from the theoretical development of this construct. This is particularly interesting when considering the VC-entrepreneur relationship: the VC trains the entrepreneur who, in turn, trains its employees and so on. Thus there is a lack of empirical research backing the Stewardship phenomena. While scholars struggle to explain the emergence of stewardship phenomena, Cable and Shane [1997] has tried to explain what happens to the VC-entrepreneur relationship if the goal misalignment should occur in the post-investment phase.

### 2.3 Prisoners dilemma theory

Whereas agency theory focuses on how the VC (principal) can control for moral hazard and adverse selection in the contractual relationship to the entrepreneur (agent) to ensure cooperative

behavior [Shepherd and Zacharakis, 2001], the Prisoner's Dilemma perspective draws from game theory and assumes that both parties could decide to act opportunistically and pursue their own narrow self-interest even though all actors are collectively better off if they cooperate [Cable and Shane, 1997]. Cable and Shane [1997] have argued that the framework is capable of describing relationship dilemmas in the VC and entrepreneur relationship. The prisoner's dilemma gives each party two possible choices: to cooperate or defect [Axelrod and Dion, 1988], and according to Cable and Shane [1997] the two actors have two main strategies;

- (1) cooperation (forgo any short-term self-interest to obtain mutual benefit), or
- (2) defection (forgo any long-term mutual benefit to obtain individual gain)

Cable and Shane [1997] argue that cooperation is the best mechanism for managing the relationship between the entrepreneur and the venture capitalist in order to optimize the performance of the venture in the post-investment phase (after they have decided to cooperate). Because both actors bring complementary assets to the venture and since these assets are specific to each individual actor, they are collectively better off by cooperating as this is critical for the success of the venture once the relationship has started [Cable and Shane, 1997]. This can be recognized as the covenantal relationship described by Hernandez [2012] and Davis et al. [1997]; "individuals express their mutual obligation to this relationship through their willingness to sacrifice short-term personal gain for longer-term, generally beneficial, collective ends" (Hernandez [2012], p. 8). As such, the collective collaboration is consistent with the aim of stewardship theory which describes the assumed goal alignment in the post-investment phase.

The pay-off each actor could obtain from a chosen strategy is, in opposite to agency theory, dictated by the strategy adopted by

the other actor in the relationship [Cable and Shane, 1997], and follows the pay-off structure of:

$$T > R > P > S \quad (1)$$

where T = temptation of extra pay-off from defection, R = reward for mutual cooperation, P = penalty for mutual defection and S = suckers pay-off (or penalty for when the sucker cooperated and the other party defected) (Cable and Shane [1997]; Shepherd and Zacharakis [2001]; Axelrod and Dion [1988]). Given that the individuals involved are rational and do not know the other actors' strategy, defection is the optimal choice of each individual actor, even though cooperation is collectively optimal for both parties [Cable and Shane, 1997]. This type of conflict could damage the venture even if both parties are acting in good faith [Zacharakis et al., 2010]. Axelrod and Dion [1988] states that if the dilemma is repeated, e.g. if there is iterative interaction in the relation which causes the actors to choose either a cooperation or defection strategy, there is a greater room for cooperation, which may lead to higher confidence in partner cooperation. Since the Prisoner's Dilemma 'game' usually is repeated, the interactions leave a chain of decisions, where both actors could observe the actions taken by the other, making reciprocity and trust critical parts in the game [Cable and Shane, 1997]. The possible defection and cooperation decisions between the entrepreneur and VC are shown in Figure 2.5.

Cable and Shane [1997] argue that the Prisoner's Dilemma framework extends the principle agent theory explanation of the VC-entrepreneur relationship, as it incorporates the issues of uncertainty and goal conflict without the restriction of a hierarchical relationship between the unequal parties. For example, the entrepreneur may view the VC's short-term strategy as detrimental to the venture's long-



term performance and may not implement the VC's approach [Zacharakis et al., 2010] or the VC may not trust the entrepreneur's management skills and under-invest. According to Zacharakis et al. [2010] opportunistic disagreements due to good faith may lead to lower overall performance, but such a "soft violence" may simultaneously lead to more constructive responses from the other party if the entrepreneur and VC can both see a resolution to the conflict where they are both better off. Furthermore, *the Prisoner's Dilemma, with trust and reciprocity extending the mere contractual nature of the relation, addresses the social context of the relationship the actors are embedded in* (Håkansson and Snehota [1995]; Cable and Shane [1997]). The reason for this is that the prisoner's dilemma framework acknowledges that other social relations in the network may influence either parties, thus contributing to a prisoner's dilemma. In the conceptual model developed by Ca-

ble and Shane [1997] the antecedents of cooperation between the parties in the VC-entrepreneur dyad are examined, i.e. time pressure, the pay-off from cooperation, information (communication and social relationship), personal similarity (relational demography, work value congruence, and relative power), and transaction procedures (bonding mechanisms, staging capital payouts, generosity, and penalties for non-cooperative behavior).

According to Shephard & Zacharakis, (2001), the model of Cable and Shane [1997] makes a contribution over and above agency theory by including the development of a social relationship between the actors in the VC-entrepreneur dyad over time. The social relationships that is developed over time due to repeated interactions in the dyad increases the likelihood of cooperation and mutual gain (Cable & Shane, 1997; Sapienza & Korsgaard, 1996).

*VC decision*

		Cooperate	Defect
<i>The entrepreneur's decision</i>	Cooperate	<b><i>Mutual cooperation</i></b> Cooperative interactions occur because both the VC and entrepreneur see a mutual gain. This could include financial gain, expert business advice, industry advice and exposure to the financial community.	<b><i>VC's defection decision</i></b> VC's may be tempted to harvest a venture's profits, under-invest in ventures or incur short-term gains of diversified time investments across more ventures by reducing the time spent on any specific venture.
	Defect	<b><i>Entrepreneur's defection decision</i></b> Information manipulation may be an attractive short-term strategy for the entrepreneur, but these short term gains from defection come at the expense of venture capitalists and will ultimately ruin the relationship.	<b><i>Mutual defection</i></b> Opportunity costs or asymmetric information may lead both parties to defect at any point in time. The probability of success for a specific venture is reduced, but they gain opportunities to promote other alternatives.

**Figure 2.5:** VC-entrepreneur relationship from a prisoner's dilemma perspective. Adapted from Cable and Shane [1997].

As argued by Arthurs and Busenitz [2003] the prisoner's dilemma typically appears when there is an eventual inflexion point in the

post-investment phase. An argument for this could be that the entrepreneur and VC does not know each other well enough in the pre-



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investment phase to evaluate the possible defection/cooperation strategies that may be chosen and therefore there it is uncertain whether cooperation will be as mutually beneficial as described in the prisoner's dilemma. If this is the case the prisoner's dilemma will appear after mutual cooperation and goal alignment has been experienced from both sides and will therefore be a cause of goal misalignment due to some sort of opportunity recognition or choice in the post-investment phase. Still, Zacharakis et al. [2010] has argued that trust is relatively less predominant in the early stage of the relationship and since the VC-entrepreneur relationship from the VC's point of view is defined more by control than by trust, this may lead to a conflict from the entrepreneur's perspective that could have negative impact on confidence in the partner cooperation. This may also lead to a prisoner's dilemma where the two parties may chose different defection strategies. Still it can be assumed that the cognitive maps of the entrepreneur and VC will differ from the pre-investment phase to the post-investment phase, assuming that both parties will increase their network and knowledge base in the longitudinal run of the relationship. In the pre-investment phase the entrepreneur and VC will have different cognitive maps and it is hard for one of the parties to analyze the consequences of the possible defection or cooperation strategies in a newborn relationship. Thus one can argue that the possible defection and cooperation strategies that may be chosen in a prisoner's dilemma situation in the post-investment stage will be more favorable in terms of cooperation due to increased trust, overlapping cognitive maps and a focus on mutual gain. Still, the framework is solely situational and can not be used to analyze the dynamic relationship-building in the process. Thus it may be more applicable as a mapping tool if a conflict should occur in the post-investment phase. Then both parties could evaluate pros and cons with the sharing of information as described in organizational learning theory.

While the model of Cable and Shane [1997] is acknowledged as a valuable contribution to the theoretical development of an explanatory model for the VC-entrepreneur relationship, Shepherd and Zacharakis [2001] argues that *there is a need for theory to further explore the social relationship aspects of developing cooperative behavior*. While the model acknowledges that personal similarity is an important factor for cooperative behavior due to reduced cognitive dissonance, improved communication and increased predictability in social interactions [Cable and Shane, 1997], it does not offer an explanation of how potential differences affect each actors perception of the other parts decisions, as e.g. cognitive dissonance could lead to a misconception of the strategies taken. In addition, Axelrod and Dion [1988] argues that one limitation of the repeated Prisoner's Dilemma model is the assumption of only two possible strategies, chosen simultaneously by the players. So the proposed existence of a Prisoner's Dilemma for both the entrepreneur and the VC negotiating the ongoing business relationship [Cable and Shane, 1997] have some limitations as the cooperation and defection decisions are not necessarily made simultaneously. The behavior and actions of the actors might not be possible to model as choosing either cooperation or defection, because before the decisions are known, the decision-making experiment will take on the Schrödinger's cat model where each party may choose to either cooperate or defect, but the decision is not known until the other party reveals its decision. Another noteworthy comment by Axelrod and Dion [1988] is that increasing the actors' interacting and taking part in the dilemma makes defection more difficult. Table 2.3 shows the limitations of the prisoner's dilemma theory in describing the VC/entrepreneur perspective in the pre- and post-investment stage.

**Table 2.3:** *Limitations to the prisoner's dilemma literature in describing the pre- and post-investment stage from both the entrepreneur and the VC's point of view.*

	Pre-investment	Post-investment	Both
VC's perspective	0	X	0
Entrepreneur's perspective	0	X	0
Both	0	X	0

\*'Both' indicates that the two keywords have been described together in the same article. X = Keyword described in framework, x = Keyword described in framework to some extent, 0 = No explanation of keyword in framework.

Although the prisoner's dilemma framework focuses on a situational dilemma scenario and its consequences from both the entrepreneur's and VC's perspective, its use has not been frequently described in the pre-investment stage and it is more situational than dynamic, which means it does not consider the ongoing relationship-building process. As the typical prisoner's dilemma will arise to both the entrepreneur and the VC in both the pre- and post-investment stage, it is applicable to both parties with no limitations to the stage of the relationship. However, since relationship conflicts as described by the prisoner's dilemma framework may occur in series as unexpected difficulties or bumps in the road appear, scholars have developed a conceptual framework to be used in the ongoing process conflict, namely procedural justice theory. The procedural justice theory is one of the dynamic relationship frameworks: *procedural justice theory, social embeddedness theory and organizational learning theory.*

## 2.4 A comparison of the three contractual VC-entrepreneur relationship frameworks

A comparison of the three discussed contractual VC-entrepreneur relationships are given in Table 6.15. The table shows how each framework addresses factors such as *contract, control, use in the pre-investment phase, limitation, area of use and actor's motivation.* These factors are chosen because they are essential in describing the VC-entrepreneur relationship and will also give an indication to what extent each framework is applicable in the pre-investment stage. The table also shows the emphasis of each framework and whether previous research has been empirically or theoretically tested. This is done to see whether the frameworks are sufficiently supported by empirical evidence and to sort out which models are based on each other.

## 3. DYNAMIC RELATIONSHIP THEORIES

While the previously described frameworks focus on the situational contract relationship in the entrepreneur and VC dyad, research has offered an alternative to the explanation of the VC-entrepreneur relationship by introducing more general relationship and network theories such as procedural justice theory, social embeddedness and organizational learning.

### 3.1 Procedural justice theory

Originally, procedural justice was developed as an extension of equity theory. This theory focused on the outcome of decisions made in an exchange relationship by considering the fairness perceived when distributing resources among the parties (Adams [1965], as cited in Sapienza and Korsgaard [1996]). Procedural justice theory considers, on the other hand, how the quality of exchange relationships affects the decision-making process and vice versa (Lind and Tyler [1988], as cited in Sapienza and Korsgaard [1996]).

**Table 2.4:** Summary of VC-entrepreneur situational contract relationship frameworks

Relationship	Principal agency theory	Stewardship theory	Prisoners dilemma
<b>Emphasis on</b>	Overemphasis on the principal (VC)	Overemphasis on the principal (VC)	Game
<b>Contract</b>	The contract is the centerpiece in the relationship.	The VC's investment contract is in essence a "buy-in" to an idea and vision established by the entrepreneur, resulting in goal congruence between the two.	Extends the mere contractual nature of the relation, addressing the social context of the relationship.
<b>Control</b>	The VC is in control. Staging of investments	The entrepreneur will remain and act like an owner after the VC invest.	Both parties are in control and mutually dependent.
<b>Use in the pre-investment and post-investment phase</b>	Applicable in the screening process of the pre-investment phase. Agency theory has mostly been applied to the post-investment stage with the assumption that there is goal incongruence between the VC and entrepreneur.	Applied in the post-investment stage where there is goal congruence between the VC and entrepreneur.	Applied in both the pre and post-investment stage when there is a goal misalignment between the VC and the entrepreneur, and possible outcomes for different strategies may be examined.
<b>Limitation</b>	Insensitive to temporal boundaries. Researchers may draw indefensible conclusions unless the timing for the use of agency theory is appropriate.	Implicitly assumes the subordination of the steward's (entrepreneur's) goals	Assumes only two possible strategies chosen simultaneously by both players. Does not offer explanation on how potential differences affect each actor's perception of the other part's decision.
<b>Area of use</b>	When there is goal incongruence between the two parties.	When the goals of the steward (entrepreneur) and principal (VC) are aligned.	Where there are uncertainties or goal conflicts
<b>Actors' motivation</b>	Self-interested	Stewards' motives are aligned with those of the principals.	Self-interested, but collectively better off with cooperation.
<b>Research</b>	Empirically tested, mostly normative assumptions.	Based on agency theory, lack of empirical research.	Theoretically based on game theory. Predominant study by Cable and Shane [1997]

In contrast to the previous frameworks that focuses on the antecedents and outcome of decisions, procedural justice examines the impact of the process of the decision-making on the quality of the relationship between entrepreneur and investor.

Opportunistic behavior holds the potential for conflicting goals between the VC and the entrepreneur, thus making it difficult to maintain a trusting and cooperative relationship [Sapienza and Korsgaard, 1996]. However, most entrepreneurs manage to maintain the relationship with their investors even during demanding periods with conflicting goals. Procedural justice theory holds a possible explanation by indicating that the reaction of individuals to the decision process tends to be more important than the decision outcome itself (Korsgaard et al., 1995; Thibaut and Walker, 1975). For instance, the entrepreneur may believe that it is the VC's responsibility to attain relevant advisors on the board whereas the VC might feel that this is the entrepreneur's responsibility. In this example the procedural justice framework would suggest that as long as the conflict solving procedure seems right to both parties, the problem could be solved in a fair manner.

Entrepreneurs have been found to willingly accept decisions, even though they do not prefer the outcome, as long as the procedure of this decision was found to be fair [Sapienza and Korsgaard, 1996]. Since procedural justice can only be applied to situations where there is a possible unfavorable outcome for one of the parties, it must be assumed that the relationship is at a stage where decisions are being made. *From a VC's perspective no decisions are done together before the first investment has been made, making procedural justice theory less applicable in the pre-investment stage.* In addition, an assumed boundary condition is that the relationship must lead to unfavorable distributive justice judgment on the part of the entrepreneur or VC before either will engage in making inferences about the fairness of the decision procedure. Thus the procedural justice theory is applicable to both the VC and

the entrepreneur in both the pre- and post-investment stage, though less frequently applied in the pre-investment stage. Table 3.2 gives the limitations of the procedural justice theory in describing the VC/entrepreneur perspective in the pre- and post-investment stage. As seen from Table 3.2 there are several articles that discusses the procedural justice theory from both the entrepreneur's and VC's perspective without applying the theory to either the pre- or post-investment stage.

**Table 3.2:** *Limitations to the procedural justice literature in describing the pre- and post-investment stage from both the entrepreneur and the VC's point of view.*

	Pre-investment	Post-investment	Both
VC's perspective	x	X	X
Entrepreneur's perspective	x	x	x
Both	0	0	X

\*'Both' indicates that the two keywords have been described together in the same article. X = Keyword described in framework, x = Keyword described in framework to some extent, 0 = No explanation of keyword in framework.

### 3.2 Social embeddedness

According to Mair and Martí [2006] social embeddedness means that it is impossible to detach the entrepreneur (agent) from the surrounding network structures [Burt, 1993], which means that the social embeddedness framework focuses on the entrepreneur in a network of continuously evolving connected relations. Earlier research has examined the economic affect of social relations and social networks, thus social embeddedness can help account for how social structure affects financial markets and business relationships (Granovet-

ter [1985]; Portes and Sensenbrenner [1993]; Romo and Schwartz [1995], Uzzi [1996], as cited in [Uzzi, 1999]).

Research on interfirm networks has suggested that economic exchanges embedded in social relations can both create *unique value* and motivate parties in the network to *share value* for their mutual benefit [Uzzi, 1999], consistent with the prisoner’s dilemma framework. Thus social embeddedness is an interesting phenomenon when examining the VC-entrepreneur relationship. In this case the embedded ties promote shared and unique value through the exchange of private resources and information [Uzzi, 1999], because both private resources and private information can help identify each actor’s dependency and expertise.

The relationship between the entrepreneur and VC is intense and simultaneously embedded in high uncertainty Clercq et al. [2006], thus being able to transfer private knowledge in exchanges may be a competitive advantage because it promotes value creation, which reveals unique possibilities for matching competences and resources with exchange partners [Uzzi, 1999]. Thus private knowledge is not only a distinctive resource, but it is hard to imitate for competitors that do not possess this knowledge. Eccles and Crane [1988], as cited in Uzzi [1999], found that VCs were able to customize deals and create innovative financial instruments for their clients in order to reduce risk when they obtained private information that the firms did not make publicly available. If turned the other way around, entrepreneurs who obtain private information about VCs are better off to choose the right investor. This means that embedded ties can give the entrepreneur and VC access to private information benefits that can channel resources and encourage solutions to investment problems that are not available through market ties. This implies that the entrepreneur’s network of ties is essential to the financing process in the pre-investment phase, but it does not explain how being socially embedded affect the quality of the VC-entrepreneur relationship.

Table 3.3 shows the ability of the social embeddedness theory to describe the VC/entrepreneur perspective in the pre- and post-investment stage.

**Table 3.3:** *Limitations to the social embeddedness literature’s ability to describe the pre- and post-investment stage from both the entrepreneur and the VC’s point of view.*

	Pre-investment	Post-investment	Both
VC’s perspective	0	x	0
Entrepreneur’s perspective	0	x	0
Both	0	0	0

\*‘Both’ indicates that the two keywords have been described together in the same article. X = Keyword described in framework, x = Keyword described in framework to some extent, 0 = No explanation of keyword in framework.

Uzzi [1999] suggests that social embeddedness will have a positive affect on the VC-entrepreneur relationship as long as the parties will obtain positive reviews from shared third parties in their network. However, Zacharakis et al. [2010] also found negative correlations between the socially embedded entrepreneur and the entrepreneur-VC relationship. For instance, high levels of conflict within the entrepreneurial team may lead to conflict between the entrepreneur and VC. Mair and Martí [2006] have also suggested that being socially embedded may constrain as well as enable the entrepreneur. This is because the entrepreneur embedded in a wide social network will gain resources and liability within the network, but on the other hand it may also lock the entrepreneur into the existing structure, which constrains the entrepreneur from seeking contact with other ventures that may challenge the existing rules and norms. Ford et al. [2010]

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calls this the network paradox. Thus as long as both parties will receive positive review from their surroundings and internal processes are not determined by conflict, social embeddedness may have a positive effect and possibly strengthen the VC-entrepreneur relationship. However, in a pre-investment phase the social embeddedness may constrain the entrepreneur from seeking contact with financial alternatives that are not bound in the existing structure.

As social embeddedness theory is applicable to both the VC and the entrepreneur in the pre- and post-investment stage, it is able to help explain the VC's and the entrepreneur's perspective on the VC-entrepreneur relationship. However, although social embeddedness explain how the network facilitates the transfer of private information, it is merely a structural framework and does not help explain the dynamic learning relationship between the VC and the entrepreneur. This could be better understood by introducing the organizational learning framework.

### 3.3 Organisational learning

Organizational learning, often referred to as knowledge-based theory [Grant, 1996], has been defined as "systematic problem solving and ongoing experimentation and the process within an organization or its capacity to maintain or to improve performance on the basis of experience" ([Garvin, 1993] and [Nevis et al., 1995], as cited in Crossan et al. [1999]). Clercq and Sapienza [2005] has defined organizational learning by the venture capital firm as "the extent to which a principal in a VCF believes he or she (or the VC as a whole) has gained new insights or broader understanding via interaction with a particular portfolio company" (Clercq and Sapienza [2005], p. 518), but this does not explain how organizational learning takes place by the entrepreneur. Crossan et al. [1999] has earlier drawn a definition of organizational learning based on previous literature as "the process by which management teams reshape their shared cognitive maps of the firm, its

markets and competitors, and through which the organization detects and corrects errors or improves its actions on the basis of increased knowledge and understanding" (Crossan et al. [1999], p. 433). This definition could be applicable to the entrepreneurial team as well as the VC team, but according to Clercq and Sapienza [2005] this definition implies that learning only takes place within individuals in an organization, e.g. either the entrepreneurial team or the VC team, whilst organizational learning could involve both individual learning and dyadic sharing between the VC and entrepreneur (Grant [1996], as cited in Clercq and Sapienza [2005]). In order to recognize the complexities associated with the process of entrepreneurial opportunities Crossan et al. [1999] has developed the 4I organizational learning framework as shown in Figure 3.6.

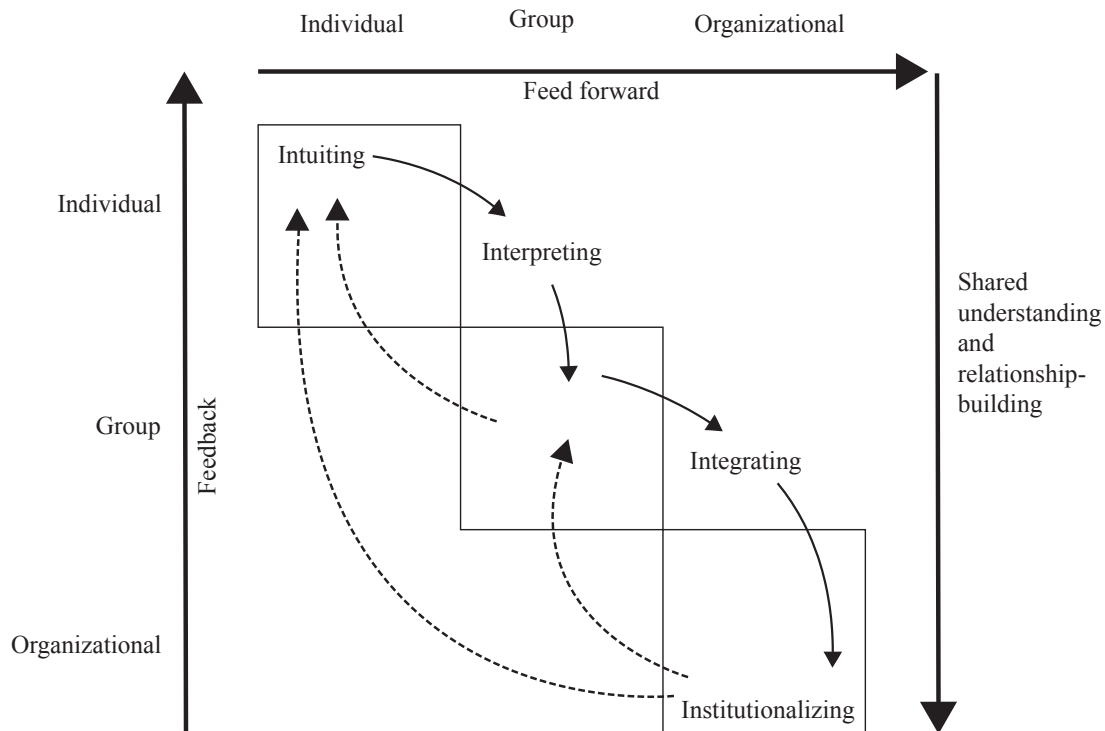
Crossan et al. [1999] points out that there exists different "schools of thought" in organizational learning. These range from the economic perspective to the developmental, the managerial learning and the process, where learning is "socially constructed" and tied to the cognitive and behavioral capability of individuals. However, in Crossan et al. [1999]'s framework the organizational learning is described as a dynamic process. Crossan et al. [1999](p. 433-434) defines the 4I learning process as follows:

**"Intuiting"** is the preconscious recognition of the pattern and/or possibilities inherent in a personal stream of experience.

**Interpreting** is the explaining of an insight, or idea to one's self and to others.

**Integrating** is the process of developing shared understanding amongst individuals and the taking of coordinated action through mutual adjustment.

**Institutionalizing** is the process of ensuring that routinized actions occur."



**Figure 3.6:** Model based on the dynamic process of organizational learning. Source: Crossan et al. [1999].

In contrast to the contractual relationship frameworks previously described, Crossan et al. [1999]’s framework depicts a dynamic process applicable to the entrepreneur-VC relationship. This framework does not exploit the contractual relationship, but rather the ongoing learning in the relationship acts as a recipe that could be applicable to both the entrepreneur and VC. As *intuition* may affect the intuitive entrepreneur’s behavior, it will only affect the VC once the VC tries to interact with the entrepreneur and vice versa. Thus the feedback loop described by the 4I Organizational Learning framework will be applicable once contact has been established and from a VC-entrepreneur perspective this will typically be at the first meeting.

Due to the great focus on learning on behalf of both the entrepreneur and VC, the organiza-

tional learning framework is highly applicable in both the pre- and post-investment phase, and it may be especially useful to both parties in the pre-investment stage since both parties know very little about each other in this period. Like procedural justice, the organizational learning framework addresses the ongoing dynamic process in the VC-entrepreneur dyad. Although greater knowledge and cognitive sharing may lead to a shared understanding and a better relationship, the framework is mostly used as a tool for obtaining knowledge and does not explicitly discuss how organizational learning may affect the entrepreneur-VC relationship. Neither does it consider how increased cognitive sharing may affect diversification in individuals and challenging points of view that may alter new and potentially better decisions. The 4I Organizational Learning framework consults

the shared cognitive maps of the entrepreneur and VC and how these maps overlap, but it says very little of how these cognitive maps are depicted and shared. Table 3.4 shows the ability of the organizational learning theory to describe the VC/entrepreneur perspective in the pre- and post-investment stage.

**Table 3.4:** *Limitations to the organizational learning literature's ability to describe the pre- and post-investment stage from both the entrepreneur and the VC's point of view.*

	Pre-investment	Post-investment	Both
VC's perspective	x	x	0
Entrepreneur's perspective	x	x	0
Both	x	0	0

\*'Both' indicates that the two keywords have been described together in the same article. X = Keyword described in framework, x = Keyword described in framework to some extent, 0 = No explanation of keyword in framework.

As seen from Table 3.4 the organizational learning theory is applicable to both the pre- and post-investment stage from both the VC's and the entrepreneur's perspective, but the lower letter 'x's indicate the theory's insufficient ability to describe the VC-entrepreneur relationship. Researchers have found that the organizational learning is most effective when the knowledge base of the venture is extensive and when new assimilated knowledge is related to the existing knowledge structure (Cohen and Levinthal [1990] and Bower and Hilgard [1981], as cited in Clercq and Sapienza [2005]). Thus for the entrepreneur the pre-

investment learning process will be most effective if the VC can contribute with relevant knowledge to the entrepreneur's existing knowledge base. Because of the dynamic validity of the model it is applicable in, but not limited to, the pre-investment phase.

### 3.4 A comparison of the three dynamic relationship frameworks

A comparison of the three dynamic VC-entrepreneur relationships are given in Table 6.15. The table shows how each framework addresses factors such as *contract*, *control*, *use in the pre-investment phase*, *limitation*, *area of use* and *actor's motivation*.

## 4. ANALYSIS AND DISCUSSION

In this paper the literature written about the VC-entrepreneur relationship has been divided into two categories; a) *contractual relationship frameworks* and b) *dynamic relationship frameworks*. The reason for this is that the agency theory, stewardship theory and prisoner's dilemma all discuss the VC-entrepreneur relationship in a contractual context. Agency theory depicts the monitoring of the contracting agent (entrepreneur) by the principal (VC) in the way that the VC puts forward a contract that ensures the VCs control to overcome agency problems. Stewardship theory builds on agency theory and sees the VC-entrepreneur relationship as a tacit contract where both parties work to obtain mutual benefits and the prisoner's dilemma discuss possible defection strategies from a presumed cooperation contract.

The procedural justice theory, social embeddedness theory and organizational learning theory on the other hand describes more dynamic processes in the relationship. The procedural justice theory describes how contract



**Table 4.1:** Summary of VC-entrepreneur dynamic relationship frameworks

Relationship	Procedural justice theory	Social embeddedness theory	Organizational learning theory
<b>Emphasis on</b>	Individuals' reactions to decisions in which they are personally invested but cannot directly or fully control.	The ability of social structure to affect financial markets and business relationships.	Individuals ability to describe and share their cognitive maps.
<b>Contract</b>	The process leading towards a contract is more important than the contract itself.	Contracts may act as a safeguard to prevent actors from sharing knowledge or switching to more valuable partners in the network.	Does not depend upon contracts since the learning process is continuous and changing.
<b>Control</b>	Entrepreneurs maintain control by yielding a level of control to the investors.	Does not affect the control in the VC-entrepreneur relationship.	Does not affect the control in the VC-entrepreneur relationship.
<b>Use in the pre-investment and post-investment phase</b>	Applicable in both the pre- and post-investment stage	Applicable in both the pre- and post-investment stage	Applicable in both the pre- and post-investment stage
<b>Limitation</b>	The theory only partially mediates relationships in situations involving high outcome uncertainty and ambiguous or nonhierarchical relationships.	Does not explain how being embedded affects the quality of the relationship.	Does not explain how cognitive maps are depicted and shared.
<b>Area of use</b>	When one party in the relationship does not have direct control over decisions.	Might give access to information benefits that may channel resources and encourage solutions to investment problems.	When there is information asymmetry between the parties.
<b>Actors' motivation</b>	The reaction of individuals to decision processes is more important than the decision outcome itself, as long as the procedure of this decision is found to be fair.	A party's positive reputation in the network may have a positive affect and strengthen the relationship.	Better information transfer minimizes information asymmetry and leads to increased trust between the parties.
<b>Research</b>	Empirical studies, predominantly in larger organizations.	Theoretically derived, lack of empirical research.	Empirical studies, predominantly in larger organizations.

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ual decision-making processes affects the relationship, which places the procedural justice theory close to the contractual relationship frameworks and makes it an appropriate crossing to the dynamic relationship frameworks. Social embeddedness explains how social ties in the VC and the entrepreneur's embedded network affect the VC-entrepreneur relationship and the organizational learning theory may explain how effective knowledge and cognitive sharing influence the VC-entrepreneur relationship. Thus it is interesting to see how the *contractual* and *dynamic* relationship frameworks differ.

#### 4.1 Literature analysis

In order to analyze the literature base in this paper, chronological tables of articles versus topics and key words were first made. Table 4.2 and Table 4.3 show the distribution of topics and key words in the literature from 1973-2012 examined in this paper. The upper six rows to the left give the relationship frameworks presented in this paper and the seven bottom rows give some relevant key words in the analysis. First we examine the key words in relation to the key words in the articles chosen for literature review. Then we proceed by comparing each framework's applicability to different stages in the investment period followed by a discussion of limitations to the relationship frameworks. Finally, we discuss how the different relationship frameworks may complement each other. In Table 4.2 and Table 4.3 distribution of frameworks or key words in articles is mapped with either a capital X or a lower letter x. The capital X indicates that the specific framework or key word is frequently described in the literature, whereas the lower letter x indicates that the specific framework or key word is mentioned in the literature, but not the main topic of the corresponding article.

The framework that has been given most

attention up till now is the principal-agency theory framework, and as Table 4.2 and Table 4.3 show most literature examined in this paper is based on agency theory and has taken the VC's point of view.

##### Column comparison

From observing the columns in Table 4.2 and Table 4.3 it can be seen that only 5 authors have made a comparison of three or more frameworks describing the VC-entrepreneur relationships. This literature include Davis et al. [1997], de Clercq and Sapienza [2001], Shepherd and Zacharakis [2001], Weber and Weber [2007] and Hernandez [2012]. It is interesting to observe that of the literature examined, agency theory has been the predominant contractual framework describing the VC-entrepreneur relationship until Cable and Shane [1997] put the prisoner's dilemma into a VC-entrepreneur context. Another observation from the columns in Table 4.2 and Table 4.3 is that the number of frameworks describing the pre- and post-investment period and which takes the entrepreneur's perspective has increased with time. Another topic that has been discussed more lately is the procedural justice framework as observed in Table 4.3, and this is an example of a topic which in particular focuses on the entrepreneur's perspective in contrast to agency theory, which mostly takes the VC's point of view.

##### Row comparison

It is interesting to see that even though *pre-investment* was one of the key words in the search for articles, only four articles discuss the VC-entrepreneur relationship merely in the pre-investment stage, whilst four of the most relevant articles discussed the relationship with emphasis on the post-investment stage even though *post-investment* had not been a key word in the search query.

**Table 4.2: Key words in articles from 1959-2000**

<b>Key word</b>	Ross [1973]	Typjee and Bruno [1984]	Williamson [1985]	Axelrod and Dion [1988]	Williamson [1988]	Eisenhardt [1989b]	Sahlman [1990]	Anderson et al. [1994]	Ehrlich et al. [1994]	Fried and Hisrich [1994]	Gompers [1995]	Håkansson and Shehota [1995]	Gompers [1996]	<i>Sapientza and Korsgaard [1996]</i>	Binks and Ennew [1997]	<i>Cable and Shane [1997]</i>	Cressy and Olofsson [1997]	<i>Davis et al. [1997]</i>	Gifford [1997]	Osnabrügge [2000]
Agency theory	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Stewardship theory																				
Prisoners dilemma			X													X		X		
Procedural justice theory												X								
Social embeddedness							X					X								
Organizational learning theory																	X			
Post-investment	X			X				X	X	X	X	X	X	X	X					X
Pre-investment								X			X						X			X
VC perspective	X	X		X			X		X	X	X	X	X	X	X	X	X	X	X	X
Entrepreneur's perspective								X								X				
Dynamic								X				X								
Empirical study						X			X	X	X	X	X	X	X		X			X
Theoretical study		X	X	X	X	X	X	X				X		X		X			X	

\*Articles comparing three or more frameworks are written in *italic bold*. X = Great emphasis on topic, x = mentioned, but not the main topic of the article.

Table 4.3: Key words in articles from 2001-2012

Key word	<i>de Clercq and Sapienza [2001]</i>	Kaplan and Stromberg [2001]	<i>Clercq and Sapienza [2001]</i>	<i>[Shepherd and Zacharakis, 2001]</i>	Douglas and Sheapher [2002]	Kaplan and Stromberg [2003]	Reid and Smith [2003]	<i>Arthurs and Busenitz [2003]</i>	<i>Neus and Walz [2005]</i>	Clercq and Sapienza [2005]	Crossan and Dutta [2005]	Schwienbacher [2005]	Smith [2005]	<i>Clercq et al. [2006]</i>	<i>Erikson and Berg-Utby [2009]</i>	Williams et al. [2006]	<i>Kaiser et al. [2007]</i>	<i>Weber and Weber [2007]</i>	Zacharakis et al. [2010]	<i>Hernandez [2012]</i>
Agency theory	X	X	x	x		X	X	X	X			X	X	X	X	X	X	X	X	X
Stewardship theory	X							x												X
Prisoners dilemma	X			X																
Procedural justice theory	X		X	X											X	X		X		
Social embeddedness	X								X		X				X		X	X		X
Organizational learning theory	X		X		X					X	X			X	X			X		X
Post-investment		X		X		X	X	X				X	X	X	X	X	X	X	X	X
Pre-investment		X		X	X	X	X		X		X		X	X					X	
VC perspective	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X	X
Entrepreneur's perspective	X		X	X	X			X			X				X		X		X	X
Dynamic	X		X	X								X	X	X	X		X		X	X
Empirical study		X				X	X			X		X				X			X	
Theoretical study			X					X	X	X	X	X	X	X	X	X	X	X	X	X

\*Articles comparing three or more frameworks are written in *italic bold*. X = Great emphasis on topic, x = mentioned, but not the main topic of the article.

## 4.2 Comparison of frameworks with key words

A comparison of frameworks with the key words *pre-investment, post-investment, VC per-*

*spective, entrepreneur's perspective, empirical study, dynamic, control* and *VC-entrepreneur relationship* is shown in Table 4.4.

**Table 4.4:** Comparison of frameworks and key words in literature when examining the VC-entrepreneur relationship.

	Pre-investment	Post-investment	VC perspective	Entrepreneur's perspective	Dynamic	Control
<i>Agency theory</i>	<b>X</b>	<b>X</b>	<b>X</b>			<b>X</b>
<i>Stewardship theory</i>	x	<b>X</b>	<b>X</b>			<b>X</b>
<i>Prisoners dilemma</i>		x	x	x		<b>X</b>
Procedural justice theory	x	<b>X</b>	x	x	<b>X</b>	x
Social embeddedness	<b>X</b>	<b>X</b>	x	x	<b>X</b>	
Organizational learning	x	x	x	x	<b>X</b>	

\*Contractual relationship frameworks are written in *italic bold*. **X** = Great correlation between framework and topic, x = Little correlation between framework and topic.

### The VC/entrepreneur perspective

The size of the capital X and the lower case x in Table 4.4 indicates the extent to which literature written about the frameworks in question focus on the particular key words. As for the prisoner's dilemma framework there has been written very little about the prisoner's dilemma in the VC-entrepreneur context. This is because the prisoner's dilemma originally was developed as a game theory and Cable and Shane [1997] were the first to apply the dilemma to the VC-entrepreneur relationship. The VC's perspective seems to have been discussed most together with agency theory and stewardship theory. When looking at the dynamic relationship frameworks the main emphasis has not

been on the VC or entrepreneur, but rather on larger organizations, inter-organizational groups and business networks. However, the frameworks have been applied to both the VC and the entrepreneur's perspective, but more often as a theoretical extension to other main frameworks than as to describe the VC-entrepreneur relationship. Table 4.4 also shows that the VC's perspective has gained more attention in literature than the entrepreneur's perspective. This is mainly due to the initial development of agency theory that became the building block of monitoring and control in the VC-entrepreneur relationship. It is also interesting to note that the frameworks have been more refined in the post-investment stage

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rather than the pre-investment stage, an observation that might be a result from observed conflicts in established relationships. The pre-investment stage is more diffuse when looking at the VC-entrepreneur relationship because no contracts have been made, thus research can only build on the experienced tacit contracts formed in the dyadic relationship.

#### **Contractual and dynamic frameworks**

As seen in Table 4.4 there seems to be a clear distinction between the key words in literature about the contractual relationship frameworks from the dynamic relationship frameworks. The contractual relationship frameworks are better at describing the parties' situational control in the VC-entrepreneur relationship whereas the dynamic relationship frameworks are better at describing dynamic change processes. Procedural justice theory seems to lie very close to the contractual relationship frameworks since it is originally a framework describing contractual decision-making processes. Still, procedural justice theory is able to explain change processes and dynamic relationship mechanisms, which places it among the dynamic relationship frameworks. Neither agency theory, stewardship theory or the prisoner's dilemma describe dynamic changes in the relationship, thus these frameworks are merely static in the sense that they describe the antecedents of and consequences in the VC-entrepreneur dyad. From Table 4.4 it might seem as if the prisoner's dilemma framework is insufficient in describing the pre-investment period of the VC-entrepreneur relationship. This is not because it does not apply to the pre-investment phase, but rather because present literature does not explain the prisoner's dilemma from a pre-investment perspective. As with stewardship theory, the prisoner's dilemma lacks empirical testing. These two frameworks are both built on previous frameworks with the aim of describing new aspects of the VC-entrepreneur relationship and they both offer theoretical contributions,

but their lack in empirical research contributes to questions such as: *How do stewardship relationships evolve? How do the cognitive maps of the entrepreneur and VC affect how the parties experience a potential prisoner's dilemma?*

### **4.3 A comparison of each framework's applicability to different stages in the investment period**

In order to discuss the applicability of the different frameworks to different stages of the investment period, Table 4.5 gives each framework's applicability in each stage of the investment period. In Table 4.5 the stages of the investment period follows the steps suggested by Arthurs and Busenitz [2003] in Figure 3.6. Thus in Table 4.5 the pre-investment period is divided into *the period before first encounter between the VC and entrepreneur* and *the pre-investment screening process*, and the post-investment period is divided into *the post-investment period* and *possible inflection points leading to goal misalignment*. Thus the time dimension has now been expanded to three periods: *Period before first encounter*, *pre-investment screening period* and *the post-investment period*.

#### **Limitations**

As Figure 3.6 and Table 4.5 show, some frameworks are more applicable than others in the different phases of the VC-entrepreneur relationship, indicating that one framework alone can only partially describe the VC-entrepreneur relationship. When looking at the upper three rows, the principal agency theory, stewardship theory and the prisoner's dilemma all focus on the antecedents and consequences of chosen decisions or different ways to monitor control. Thus procedural justice, social embeddedness and organizational learning theory in the bottom three rows may add a dynamic perspective to the VC-entrepreneur relationship models.

**Table 4.5:** *Phases of application for the different frameworks.*

	Period before first encounter between the VC and entrepreneur	Pre-investment screening process	The post-investment period	Possible inflection points leading to goal misalignment
<b>Agency theory</b>	Not applicable	Highly applicable for the VC to monitor a potential agency problem.	Applicable to the extent the parties cannot obtain full goal congruency.	Applicable in the way the VC may use contracts to protect from defection problems.
<b>Stewardship theory</b>	Not applicable	Applicable to the extent one of the parties may steward the other to see mutual benefit.	Highly applicable due to a potential high level of goal congruence between the VC and entrepreneur	Applicable to the extent one of the parties may steward the other to see mutual benefit.
<b>Prisoners dilemma</b>	Not applicable	Applicable since both the entrepreneur and the VC may act opportunistically.	Less applicable, may occur in minor disagreements.	Highly applicable
<b>Procedural justice theory</b>	Not applicable	Applicable to some extent in the screening-decisions	Highly applicable in the everyday decision-making processes in the venture.	Highly applicable in conflict resolving decisions.
<b>Social embeddedness</b>	Highly applicable in the way the entrepreneur and VC may use their network to search for potential investors or investment cases.	Both the VC and entrepreneur may use their network to gain due diligence information about the other party to help with the decision.	Applicable to the extent social embeddedness may influence one party's feelings towards the other.	Applicable to the extent one party can use it's network to reveal a potential prisoner's dilemma by gaining information about a potential defection strategy of the other.
<b>Organizational learning</b>	Not applicable in the VC-entrepreneur context since they have not yet met.	Applicable to the extent both parties can learn from each other to obtain a shared understanding and higher goal congruence.	Applicable to the extent both parties may learn from each other to overcome information asymmetry.	Applicable to the extent both parties may share each others thoughts in order to uncover the different cooperation/defection strategies.

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The limitation of the dynamic frameworks is that they are based on organizational theory and business networks and have not explicitly been derived from or developed based on studies of the VC-entrepreneur relationships, thus they do not explain how social embeddedness and organizational learning is depicted from the VC-entrepreneur perspective. Only procedural justice and the prisoner's dilemma partially attempt to take the entrepreneur's view on the relational decision-making process, as seen in Table 4.4. Thus there is still a need to capture how the entrepreneur looks upon the relationship-building context and what processes and factors affect how fairness, trust and commitment is being perceived in the relationship. When observing columns, an interesting observation is that neither agency theory, stewardship theory, prisoner's dilemma or procedural justice theory is applicable in the early pre-investment period, before the first encounter between the VC and entrepreneur, but social embeddedness is. Thus the social embeddedness could help the entrepreneur and VC with getting a better understanding of how these initial relationships develop. The previously described frameworks have been shown to be more applicable in some time intervals than others, thus it is necessary to see how these overlap and complement each other in order to describe how the dynamic VC-entrepreneur relationship evolve.

#### **4.4 How relationship frameworks may complement each other**

The previously described frameworks have all discussed the opportunistic behavior inherent in agency theory, how it could be overcome and antecedents and consequences of dilemmas that might occur. By withholding information, the entrepreneurs could lose the trust and support they enjoy from their investors if they do not feel that both parties work towards a mutual gain, thus inducing enhanced monitoring which, in turn, hampers their future timely need of funding [Sapienza

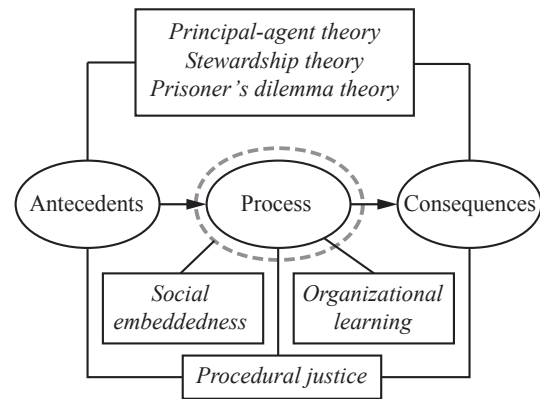
and Korsgaard, 1996]. Such an opportunistic behavior could also lead the entrepreneur or VC to choose a defection strategy in accordance with the prisoner's dilemma, which may lead to short-term gains. This might be overcome by using *organizational learning theory* and *procedural justice theory*. On the other hand, sharing all information could also lead to a loss of leverage, and shake investors' confidence at an early stage [Sapienza and Korsgaard, 1996]. However, this focus on opportunistic behavior does not take into account the found effects of cooperation [Ehrlich et al., 1994], which could be modeled with the stewardship model and the procedural justice theory, which several scholars have pointed out as a means of understanding the aspects of the relationship between the entrepreneur and the VC (Arthurs and Busenitz [2003]; Sapienza and Korsgaard [1996]; Cable and Shane [1997]; Fried and Hisrich [1994]). As VCs may be considered more concerned about problems associated with moral hazard and adverse selection than the entrepreneurs, it can be assumed that more VCs will choose the principal-agent model. Entrepreneurs on the other hand could be considered likely to follow process elements, in terms of dynamic frameworks, that would lead to a good relationship to their investor.

According to Davis et al. [1997] the prisoner's dilemma can model the choice between a principal-agent relationship and a stewardship relationship due to the psychological characteristics of each individual in the party that predisposes that individual to make a choice, but these three frameworks are still situational and merely focus on the effects of given situations. In a typical prisoner's dilemma the decision is taken *simultaneously* by both parties and each party's expectation towards the other will influence the choice between stressing agency or stewardship elements in the relationship. Many factors may influence the chosen relationship model, such as trust, management philosophy, cultural background, network effects, information and cognitive maps, but these factors are all part of a process leading up to the given



situation. Cable and Shane [1997] examined only two persons, namely the entrepreneur and VC in the prisoner's dilemma model, but as Cable and Shane [1997] pointed out in their article, the two-person prisoner's dilemma between the entrepreneur and VC is embedded in a wider network of n-persons prisoner's dilemma that consists of all entrepreneurs and VCs. Cable and Shane [1997] also suggest that other actors may be incorporated in the model. Thus the VC and entrepreneur are both embedded in a wider network of relations that could potentially influence the relationship between the two, thus introducing social embeddedness can help extend the prisoner's dilemma framework. Organizational learning and procedural justice may, in this case, effectuate information sharing and increase the fairness of the decision which, in turn, may lead to mutual cooperation (prisoner's dilemma), goal congruence (stewardship theory) or adverse selection and moral hazard (principal-agency theory). Principal-agent theory is based on adverse selection and moral hazard, a consequence of information asymmetry which organizational learning and social embeddedness may help explain. Hernandez [2012] suggests that stewardship behavior may be a consequence of control/reward systems and cognitive mechanisms, where procedural justice theory and social embeddedness theory is part of the process resulting in stewardship behavior. While procedural justice focus on dynamic decision-making processes in the relationship it differs from the other dynamic relationship frameworks in the way it focus on how precautions can be made to mediate the relationship between the VC and entrepreneur. It is therefore a preventive framework used to avoid conflicting goals and unfair decisions between the two parties, thus it is somewhat close to the contractual relationship frameworks in the way they discuss how antecedents may result in positive outcomes, but even closer to the dynamic relationship frameworks due to its focus on the dynamic process. Figure 4.7 shows how the different frameworks capture antecedents, process and consequences of the VC-entrepreneur

relationship.



**Figure 4.7:** How the frameworks capture antecedents, process and consequences of the VC-entrepreneur relationship.

As seen from Figure 4.7 the frameworks differ in their approach to explain the VC-entrepreneur relationship although they still overlap in some areas. However, as shown in Table 6.15 and Table 4.1 these frameworks relate differently to the VC-entrepreneur relationship phenomenon. Thus some areas that are highly interrelated between different frameworks may together help gain a better understanding of the VC-entrepreneur relationship whilst in other frameworks that differ greatly in their approach to the phenomenon such additive theory building may not yield a better explanation. By integrating all 6 frameworks into a single, but more comprehensive model we might be able to confine some factors discussed in the literature and give insight to antecedents and processes elements leading up to certain behaviors of the VC and the entrepreneur depicted by the contractual relationship frameworks. However, such a model aiming to include all aspects of the VC-entrepreneur relationship would not be useful as it would be impossible to map all aspects of the relationship as this would result in a mere replica of reality, and as expressed by (p. 37-38) "models are abstraction of reality. They are not replicas of it."

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Such a comprehensive model would be able to picture both the VC's and the entrepreneur's point of view and would contain dynamic relationship processes making such a model highly applicable to both the pre- and post-investment stage, but it would be impossible to map such a model in full scale and detail. However, this paper does not aim to develop a comprehensive model of all complementary frameworks, but rather to give an overview of the application and limitation of each framework's ability to describe areas in the pre- and post-investment stage and from the VC and the entrepreneur's perspective.

## 5. CONCLUSION

Frameworks such as *stewardship theory* and *prisoner's dilemma* build on agency theory and acknowledges that relationship dilemmas can be seen from both the VC's and the entrepreneur's perspective while the principal-agent theory solely focuses on the VC perspective. These contractual frameworks are situational and more, or less, applicable to different phases of the VC-entrepreneur relationship. Thus other more dynamic frameworks can add an explanation to the process and how the many concepts are simultaneously present, and highly interrelated, in an on-going relationship. *Procedural justice*, *social embeddedness* and *organizational learning* are such frameworks that explain the ever-changing evolving relationship, and in the pre- and post-investment period these frameworks are applicable to some extent, thus these theoretical foundations may complement the situational frameworks. These dynamic frameworks can be seen from both the VC and the entrepreneur's perspective and thus enable the entrepreneur's point of view. While the contractual frameworks acknowledges the consequences of cooperative behavior between the VC and entrepreneur, *social embeddedness* and *organizational learning* suggest that the VC-entrepreneur relationship is embedded in a wider business network, affected by inter- and intra-organizational relationships, and that network effects may play a significant

role in explaining how trust, cooperation and commitment aspects of the VC-Entrepreneur dyad evolves. Much research is confined to the post-investment process and although some frameworks are able to explain areas of the pre-investment process *there is a lack of research in the early pre-investment period* where the first encounter between the VC and the entrepreneur has not taken place.

## 6. IMPLICATIONS FOR THE VC AND ENTREPRENEUR

Our analysis and discussion indicate that the VC-entrepreneur relationship is highly influenced by psychological understandings such as *trust*, *confidence* and *cognitive sharing*. A consequence of this is that the VC-entrepreneur relationship is not only determined by contractual monitoring models, but also individual cognitive maps due to different perceptions and interpretations, since a shared understanding is important for both parties to obtain a mutual understanding. Our analysis and discussion indicate that although agency theory has been the main focus in the VC perspective, other frameworks may be able to explain areas where agency-theory has seemed insufficient. Thus VCs should focus on carrying out fair decision-making processes in order to obtain a trustful relationship to the entrepreneurs and should seek to develop decent tools for sharing knowledge with the entrepreneur in order to overcome the potential information asymmetry. The entrepreneur should be aware of methods used to obtain knowledge, reputation, fair decision-making processes and cognitive sharing that might influence and lead to a good relationship to the investor. The entrepreneur should also understand the consequences of different approaches in the relationship-process in order to fully understand how elements may affect the future dynamic relationship to the investor. Furthermore both the VC and the entrepreneur need to be aware of how they might inspire action and understand their own behavior as well as the behavior of others.

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## 7. IMPLICATIONS FOR FURTHER RESEARCH

Further research should focus on the initial development of the VC-entrepreneur relationships and add to existing theories by explaining the relationship-building process, not only from the VC's point of view, but from the entrepreneurs perspective. Much theory has been written about the screening and pre-investment period from the VC's point of view, but there is still a lack of explaining actions as to how the entrepreneur develop relationships to investors even before the two parties first meet. Thus possible research questions could be: *How does the entrepreneur initiate relationships to investors in an very early phase? How do inexperienced entrepreneurs build a successful relationship to investors?* As such processes are comprehensive and complex such research areas could be empirically tested with qualitative research methods in terms of explorative case studies. More emphasis should also be put on testing theoretical models such as *stewardship theory* and *the prisoner's dilemma* empirically. As these contractual frameworks describe situational relationships these research areas are highly suitable for quantitative research methods. To see how dynamic and complex relationship frameworks, such as social embeddedness and organizational learning, may affect the VC-entrepreneur relationship, this could be qualitatively measured by addressing contacts in the network of the VC or entrepreneur that directly or indirectly influence the relationship. From the entrepreneur's perspective an interesting area of research would be to examine how the use of external relations may influence the VC-entrepreneur relationship. Possible research questions could be *How can outside directors add legitimacy to the entrepreneur team when seeking investor funding? How can external relations mediate the relationship between entrepreneurial ventures and equity investors?.* Another interesting topic would be to perform a longitudinal case study by following a VC in meetings with several entrepreneurs. Since there has been little quantitative research on the role of so-

cial embeddedness and organizational learning from the entrepreneur's perspective in the early pre-investment period we suggest that further research should focus on explorative case analysis on entrepreneurial ventures and their process of building relationships to investors. This could be done by performing explorative case studies on process elements in early-stage entrepreneurial ventures seeking or about to seek investments.

## 8. LIMITATIONS

The authors have been limited to perform the literature screening through databases that NTNU has permission to download from, which may have led to a blind spot to relevant articles in unavailable databases. Although some articles may have been excluded from the databases used by NTNU, this number is limited since extensive effort has been devoted to acquire articles that are frequently cited in relevant literature, but not available through the NTNU databases. Some articles have also been acquired by the use of *snowballing*, thus the results may be biased by the academic background and cognitive maps of our references. The authors are also working entrepreneurs themselves, something that cause bias in the choice of key words in the literature search due to the authors' own understanding of the problem.

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# Investigating how outside directors may strengthen entrepreneurial ventures in an early stage

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## Abstract

*This article uses the case study method to explore how outside directors in Norwegian high growth ventures may strengthen entrepreneurial ventures in an early stage. Our case study contribute to insights in the use of outside directors, an area where there has been none, or limited, research up till now. Our findings show that the outside directors may contribute to scarce resources by adding organizational, human and social resources consistent with the resource based view, and also increase the ventures interaction with its surroundings by co-optation and added legitimacy in accordance with the resource dependence view. However, what enables the entrepreneur to take advantage of resources obtained from outside directors seems to depend upon the outside director's ability to convey knowledge into a language the CEO understands. Our findings suggest that the outside directors may add legitimacy by their reputation, CV, experience and trustworthy relationships and the legitimating role seemed to be situational and vary with the stage of the company. Outside directors seem to help ventures with their monitoring and control of resources by strategically combining internal and external resources and fostering stewardship behavior and our findings indicate that the value-adding role of the outside director to these high-growth ventures in the early-stage may depend upon the stage of the company and of the extent of the outside director's activity in the firm.*

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## 1. INTRODUCTION

The founding of new high growth businesses is often regarded to be important for both global innovation and economic growth (Schoonhoven and Romanelli [2001]; Shane and Cable [2002]). However, the positive impact of entrepreneurial ventures is dependent on the successful realization of the founding idea, and although it is fairly easy for just about anyone with an idea to launch a new company, building a sustainable, high growth business is challenging. Entrepreneurial ventures in an early stage are often characterized by having few entrepreneurs, a business plan that is not validated, and undeveloped technology and business concept Clercq et al. [2006], moreover, the technology, contacts, and industry knowledge are commonly constricted to the founding team [Brush et al., 2001]. Thus, at an early stage the internal resources in entrepreneurial ventures are often scarce or non-existing (Brush et al. [2001]; Gabrielson and Huse [2005]).

The challenges of building high growth businesses is also associated with the ability to attract new resources [Brush et al., 2001]. Entrepreneurial ventures in an early stage often lack the reputation associated with a record of performance (i.e. administrative history, a loyal customer base, and shared experience), and thus potential external stakeholders increase their perception of the risk involved with the new venture (Brush et al. [2001]; Clercq et al. [2006]; Huse [2011]). Brush et al. [2001] also posits that seeking advice from your network, assessing different decision criteria of equity providers, delegation of responsibility, setting policies and developing controls in the company are among the initial challenges the entrepreneurs face when constructing a resource base. Thus, there is not only a challenge in accessing limited resources, but also a challenge related to controlling and monitoring these resources.

In order to increase the chances of a successful realization of the founding idea the entrepreneurs needs access to the much-required reputation, resources, and the ability to mon-

itor and control the use of these resources. As high risk is associated with early stage ventures' so-called 'liability of newness' [Kor and Misangyi, 2008], help with monitoring and control of scarce resources must be found. Deakins et al. [2000] suggests that appointing an outside director to the venture may be a way to obtain such control over resources in the company and share and deflect some of the entrepreneur's responsibility. Gabrielson and Huse [2005] argues that outside directors may be value adding contributors to entrepreneurial firms by "helping to initiate and maintain control over critical relationships, assets and contacts in the external environment of the firm"[Gabrielson and Huse, 2005, p. 29]. Kor and Misangyi (2008) found that in young entrepreneurial firms outside directors with significant managerial industry experience were able to mitigate the same resource lack among the top-management. Other researchers propose that outside directors are able to influence the entrepreneurial firms' growth strategies, approaches to marketing, strategic planning and other needed competences (Deakins et al., 2001). As Deakins (2000, p. 115) suggest, the outside directors may also "include bringing improved discipline to board meetings, existing leadership skills and improving the functioning of the board" (Pettigrew [1992]; Mileham [1995]; McNulty and Pettigrew [1996], as cited in Deakins [2000], p. 15). Thus outside directors may not only contribute with the monitoring and control of resources, but may also add to scarce resources and increase the ventures interactions with its surroundings.

Huse (2000)'s review of research of board of directors in SMEs shows that the literature on the subject is still fragmented and in its infancy, thus this paper aim to explore *how outside directors may strengthen high-growth entrepreneurial ventures in an early stage*. Board composition in large organizations have been the subject of much research, however little research has been performed on the board of directors in start-ups, and there is even more lack in research of



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the use of outside directors in high technology start-ups (Clarysse et al. 2007). Thus we will base our research on the outside directors' contribution on the following research questions:

1. *How can outside directors add scarce resources to high-growth entrepreneurial ventures in an early stage?*
2. *How can outside directors add the needed legitimacy to high-growth entrepreneurial ventures in an early stage?*
3. *How can outside directors help the board in high-growth entrepreneurial ventures to monitor and control the use of resources in an early stage?*

In this article we first present extant literature on the role of outside directors in entrepreneurial ventures in terms of value creation, monitoring and control. This review gives a foundation for an explorative analysis of three cases consisting of high-growth Norwegian entrepreneurial ventures, all of which have acquired outside directors at an early stage. The findings in each case is presented followed by a within-analysis of each case company. The three cases are then compared in across-case analysis followed by a discussion on how the case findings correspond with theory in order to answer our three research questions. Finally we offer a conclusion and offer some directions for future research.

## 2. THEORETICAL BACKGROUND

The resource-based view, resource dependence view, agency theory and stewardship theory have all been applied to describe the many different roles of outside directors. However, the entrepreneurs reason for recruiting outside directors and their perceived contribution seem to vary across theories [Gabrielsson and Huse, 2005]. Lynall et al. [2003] suggests that it is "not a matter of choosing one theoretical perspective over another but, rather, of identifying under which conditions each is more applicable" [p. 419]. As a frame of reference we have

therefore chosen to divide the theory applied to outside directors into *value creation* and *monitoring and control*.

### 2.1 Value Creation

The value creation in a firm consists of developing and obtaining resources and strategies needed for venture success [Hitt et al., 2001]. Two perspectives are often used to evaluate the value creation in new ventures: the *resource-based view*, providing an internal focus, and the *resource dependence view*, providing an external focus [Bjørnåli, 2009].

*Resource-Based View* argues that a firms competitive advantage lies with the application of its internal resources and capabilities (Helfat and Peteraf [2003], Prahalad and Hamel [1990]). Being able to further develop and maintain these resources will, hence, strengthen the firms competitive position [Gabrielsson and Huse, 2005]. From a resource-based view the firm strategy should thus seek to leverage their internal strengths and minimize their internal weaknesses [Barney, 1991].

By sorting resources into six categories: human, social, financial, physical, technology, and organizational, and further range their complexity on a scale from simple (i.e. tangible, discrete, and property-based) to complex (i.e. intangible, systemic, and knowledge-based), Brush et al. [2001] propose that the more complex a resource is, the higher potential for further transformation, combination and possible unique advantage there is. To create a competitive advantage, the resource-based view focuses on the company's capabilities in addition to its assets. Capabilities are defined by Helfat and Peteraf [2003] as: "the ability to perform a coordinated set of tasks, utilizing organizational resources, for the purpose of achieving a particular end result" [p. 999].

However, entrepreneurial firms often lack the strength of internal resources and sometimes in-house knowledge [Storey, 1994], thus the entrepreneur team is pressured to depend on their environment for the attraction of

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needed resources and knowledge [Clarysse et al., 2007]. Brush et al. [2001] moreover argues that the entrepreneurial challenge is to construct a resource base: "identifying, specifying, combining, and transforming personal resources into a new venture"[p. 77]. Castaldi and Wortman [1984] (Cited in Gabrielsson and Huse [2005]) found that by bringing outside directors into the board, the firm were able to meet the internal need for resources in knowledge, experience and skills. Hence, the relevant outside directors could provide a competitive advantage and strengthen the firms competitive position through their competence and personal qualifications [Gabrielsson and Huse, 2005]. By utilizing outside directors' resources and knowledge, firms have also been able to increase their strategic flexibility [Zahra and Filatotchev, 2004], and by taking a strategic role outside directors have been found to affect the firm's competitive position, and achieve goal congruence between the shareholders interest, and the firms goals [Tricker, 1994].

*Resource Dependence View* argues that the behavior of a company is influenced by external resources, and that the procurement of these resources is a necessity to ensure a competitive strategy of any company [Salancik and Pfeffer, 1978]. Thus, the company is viewed as an open system depending on external stakeholders and environmental eventualities [Salancik and Pfeffer, 1978]. As companies rely on the interaction with its environment through procurement and distribution, Salancik and Pfeffer [1978] argues that in order to reduce environmental uncertainty, companies must strive to stabilize the flow of resources through environmental control. However, entrepreneurial ventures in an early stage often consists of a small group of founders and lack the ability and network to mobilize external resources needed for further development [Clercq et al., 2006]. By utilizing the outside directors as a linking mechanism between the organization and its environment [Pfeffer, 1972], through connection, co-optation, and legitimacy (Pfeffer [1972]; Salancik and Pfeffer [1978]), the managers may

achieve various objectives concerning its resource dependencies (Zahra and Pearce [1989] as cited in Gabrielsson and Huse [2005]). Thus they effectively help reducing environmental uncertainty [Pfeffer, 1972]. Outside directors' extended network connects the company to external organizations [Salancik and Pfeffer, 1978], and co-optation occurs when the outside directors use their extended network to obtain representatives of powerful stakeholders to the board [Pfeffer, 1972]. The combination of outside directors' extended network and ability to co-opt new strategically important board members, is associated with decreased firm dependency [Salancik and Pfeffer, 1978].

The outside directors provides legitimacy, when "the prestige and reputation of the directors in the stakeholder groups enable the board to legitimize the firm's actions, mobilize external support and acquire critical external resources" (Salancik and Pfeffer [1978], as cited in Bjørnåli [2009][p. 12]). Young firms are associated with lack of resources, and inability to develop relations with potential stakeholders. These factors correspond with their relatively high rate of mortality, also referred to as "the liability of newness" (Stinchcombe [1965] as cited in (Deutsch and Ross [2003]; Kor and Misangyi [2008])). Deutsch and Ross [2003] showed that high- quality young firms could enhance their chances of survival, and credibly signal their superiority to other entrepreneurial firms, in a market where stakeholders refuse to align themselves with new ventures, by obtaining reputable directors to their boards.

## 2.2 Monitoring and Control

Most research on the control function of external directors has concerned larger companies (Pfeffer [1972]; Lynall et al. [2003]; Huse [1998]). However, Gabrielsson [2007] found that the use of board empowerment in small companies is a response aimed at satisfying the demands from owners not directly involved in managing the company. Agency theory is often used to describe the investor-entrepreneur relationship

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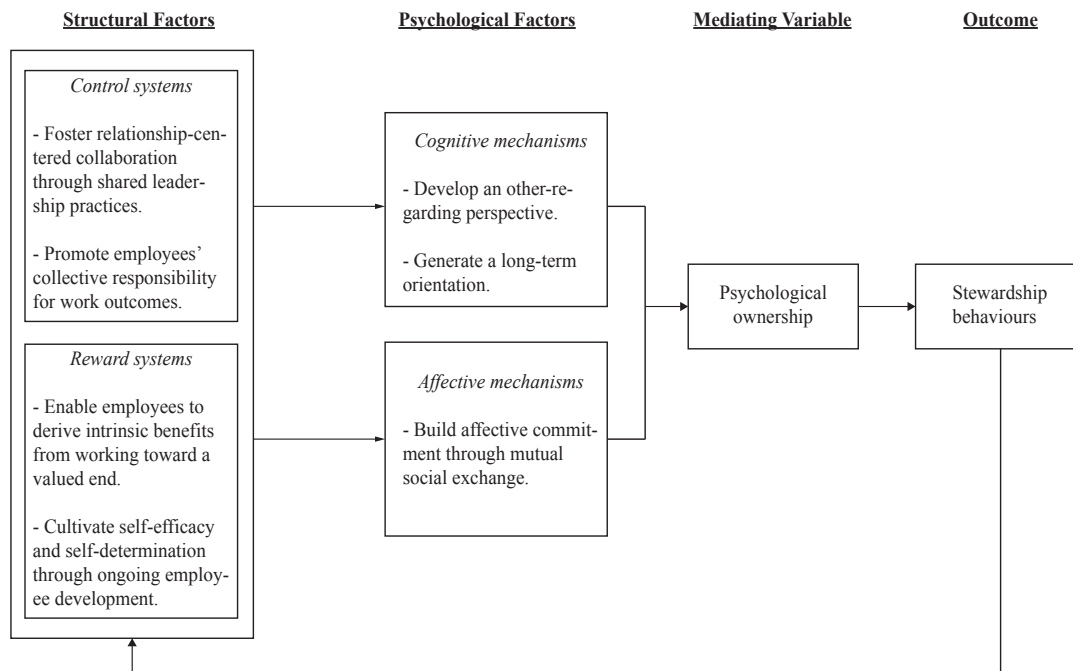
and explains how outside directors, on behalf of the shareholders (principal) can be used as a method to control, monitor and influence the top management (agent) [Keasey et al., 1997], where there are agency costs involved with the separation of ownership and control for the shareholders [Fama and Jensen, 1983]. However, in early stage ventures the entrepreneur usually inherits a double role as the entrepreneur often holds the position as both owner and manager [Brockhaus, 1980], thus there can be no agency problem since the owner and manager is the very same person [Deakins et al., 2000]. Thus Deakins et al. [2000] suggests that outside directors may contribute to monitoring and control in early-stage ventures through contractual relationships, based on the propositions within stewardship theory, on behalf of the shareholders, even when the shareholder and the manager is the same person. Stewardship theory posits that there is no inherent problem of executive motivation among entrepreneurs and Hernandez [2012] describes this as a covenantal relationship where there is goal congruence between the two parties. Stewardship theory therefore describe entrepreneurs as stewards whose motives are aligned with their principals.

While agency theory models the VC and entrepreneur as self-interested actors rationally maximizing their own personal economic gains, this model presumes the notion of an in-built conflict of interest between the VC and entrepreneur [Davis et al., 1997]. Hernandez [2012] defines stewardship as “the extent to which an individual willingly subjugates his or her personal interests to act in protection of others’ long-term welfare” [Hernandez [2012], p. 8], and describes the relationship as a covenantal relationship in which a moral commitment binds both parties to work toward a common goal without taking advantage of each other. In this model the entrepreneur essentially wants to do a good job, thus being a good steward of the corporate assets [Davis et al., 1997].

Hernandez [2012] has created a model of the suggested antecedents that drive stewardship behavior as shown in Figure 2.1. This model posits that the cognitive and affective

variables that drive stewardship behavior are affected by the structural factors of stewardship governance. The stewardship theory posits that there is no inherent, general problem of executive motivation among entrepreneurs [Davis et al., 1997]. In such a covenantal relationship both the outside director and the entrepreneur recognize their fiduciary obligations to protect the interests of stakeholders and the entrepreneur also believes he is morally obliged to pursue these interests [Caldwell et al. [2002], as cited in Hernandez [2012]]. For outside directors appointed by ventures at an early stage where the entrepreneur holds the position as both owner and manager there can be assumed to be goal congruence, thus the question is how far the entrepreneurs can achieve a good venture performance Donaldson and Davis [1991]. In contrast to agency theory, stewardship theory is based on elements from sociology and psychology and offers an alternative view in which organizational actors see greater long-term profit in other-focused, prosocial behavior rather than the self-serving and short-term opportunistic behavior described in agency theory [Hernandez, 2012]. Thus, stewardship theory is to a greater extent able to describe the relationship in the post-investment phase where the goals between the parties are aligned.

Deakins et al. [2000] suggests that outside directors in early-stage entrepreneurial ventures may bring improved discipline to board meetings, exercise leadership skills and improve the functioning of the board (Pettigrew 1992; Mileham 1995; McNulty and Pettigrew 1996, as cited in Deakins et al. [2000]). However, the relationship between the outside directors and CEOs has received little attention in research despite the high profile that comes with the position as an external director (McNulty and Pettigre (1996), as cited in Deakins et al. [2000]) and most research on the control function of external directors have been appointed to larger companies (Pfeffer [1972]; Lynall et al. [2003]; Huse [1998]). Thus there is a need to investigate further how outside directors may help boards in high-growth ventures to monitor and control their use of resources at an early stage.



**Figure 2.1:** A model of stewardship antecedents. Source: Hernandez [2012]

### 3. RESEARCH METHOD

This article uses the case study method to examine how outside directors strengthen high-growth entrepreneurial ventures at an early stage. Yin [1989] defines a case study as ‘an empirical inquiry that investigates a contemporary phenomenon within its real-life context when the boundaries between phenomenon and context are not clearly evident and in which multiple sources of evidence are used’ (Yin [1989], p. 23).

#### 3.1 Case study method used to examine the role of the outside directors

Because of the unique strategic composition of boards in the start-up phase and the rapid

changes that takes place in new ventures, case research enables a holistic description of each case and offer depth in and comprehensiveness of situations in order to understand the strengthening roles of the outside directors to high-growth ventures at an early stage. Because little is written about the roles of outside directors in the pre-investment phase, it is especially relevant to take a case study approach since it may add insight into areas where current theories seem inadequate ([Yin, 1989]; [Eisenhardt, 1989]). As the pre-investment period for high-growth ventures may be complex, case study research may capture the processes and allow research on both contextual factors and process elements in the same situation [Halinen and Törnroos, 2005].

Yin [1989] separates between *exploratory*, *descriptive* and *explanatory* case studies. In our

study the factors contributing to the strengthening role of the outside directors to high-growth entrepreneurial ventures at an early stage is unknown, thus this article is based on *exploratory* case research.

### 3.2 Case selection

Given our research questions, we sampled CEO's and outside directors from three Norwegian high-growth entrepreneurial ventures. Due to our area of research we narrowed the search down to young entrepreneurial ventures that had obtained an outside director that did not have any connection to anyone in the entrepreneurial team or the venture in general. In order to be able to carry out an explorative study of how the outside director might strengthen the ventures at an early stage we had to narrow our search down to ventures where the outside director had been onboard for more than 6 months. In this way we made sure that the outside director and entrepreneur would have had time to develop a relationship between them that would make both parties able to evaluate to what extent the outside director has contributed to strengthening the venture at an early stage. In this study we have conducted case analyses of 3 high-growth Norwegian ventures in their pre-investment phase. The selected companies were of high relevance because they had all initially searched for an outside director to obtain help in a critical pe-

riod, and all three companies had reached important milestones during the period in which the outside director was appointed. Thus it is interesting to explore in which ways the outside directors might have strengthened the entrepreneurial ventures during this period.

### 3.3 Data collection

The data consists of in-depth interviews with CEOs and outside directors in the three companies. The sources of interviews are given in Table 3.1, where the outside director A,B was the same in both company A and in company B. Each interview lasted on average 1 hour and some informants were interviewed more than once. An interview guide was prepared in advance of the interviews to ensure that we obtained relevant information related to our research questions. As new relevant information was obtained during the interviews, we performed stepwise iterations between the informants and the interview guide, which resulted in new aspects related to our research questions as we went along. All interviewees were tape recorded and the interviews were conducted in the period April 2013 and June 2013. As tentative propositions and causal relationships emerged in the interviews we made sure to follow-up by asking affirmative questions as a sanity check to ensure that we had understood the accounts given correctly.

**Table 3.1:** Sources of the interview data

venture	Entrepreneur	Board member
venture A	CEO A	Outside chief of director A,B
venture B	CEO B	Outside chief of director A,B
venture C	CEO C	Outside director C

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### 3.4 Data coding

The data were first coded into a number of categories as suggested in the theoretical model proposed by Yin [1989]. The categories were:

1. Relationship context factors.
2. The perception of the outside director's value-adding to the venture.
3. The venture's management structure.
4. The outside director's legitimating role.
5. The main task of the board.
6. Monitoring and control by the outside director.
7. Changes that have occurred in each of the above areas.

### 3.5 Case analysis method

After completing the initial interviews with the CEOs and the outside directors, the data were analyzed by first transcribing the recorded interviews into written text. Since the interviewees were Norwegian the interviews had also been conducted in Norwegian which means that all transcriptions were made in the Norwegian language. First, quotes were extracted and given keywords in order to compare the two perspectives in each case, and then these

quotes were translated into English and tabulated.

A key advantage of the inductive process is that it allows constructs to emerge from the data rather than being guided by hypotheses. We therefore first performed within-analysis of each company by looking for similarities and differences between the CEO's perception and the outside director's perception of each research question. For the within-case analysis of the embedded units (company A, company B and company C) we used the standard cross-case analysis technique Eisenhardt [1989b] by looking for similarities and differences between each interviewee. Through the logic of replication we were able to develop initial propositions of the outside director's strengthening role to high-growth entrepreneurial ventures at an early stage. As the data were revisited quite often constructs, causal relationships and propositions emerged. Finally, the results from the within-analysis in each company were compared in a cross-case analysis between the three cases.

## 4. PRESENTATION OF THE CASES

As proposed by Huse [2000] there is a need to understand the contextual conditions under which small companies adopt outside directors. Hence, Table 5.3 gives the context of each company's present situation.

**Table 4.2:** *Context of company A, company B and company C*

Company A	Company B	Company C
The entrepreneur has obtained several propositions from investors who wish to buy the company, but contact has been very situational and until now no investments has been made. Investors is not really of interest to the entrepreneur and the meetings with investors have often been initiated by the outside director.	Has obtained funding from business angels obtained from the local environment, friends and acquaintances. These are close relationships. The entrepreneur has also presented to bigger investors and been declined because they applied for an insufficient amount of money. The entrepreneur has been advised by the outside director to use the bank in order to find new relevant investors. Company B was sold in 2010.	Company was funded in 2009 and today they have obtained several crucial partners in order to enter the market. The CEO has always had a lot to do since he has been working alone with sales and business development. The CEO is currently working on expanding the business in Nordic countries.

**Table 4.3:** Experience of CEO and outside director in company A, company B and company C

Coding category	CEO	Outside director
Case A	<p><b>Education and experience:</b> MSc in engineering. Founded company A in 2001 and has been working as CEO since then.</p> <p><b>Expectation to outside director:</b> Someone who could make the team better at their internal operations. Someone with the necessary experience and competence to help them get a better understanding of the "bigger picture".</p>	<p><b>Education and experience:</b> Has worked as key account manager, chief financial officer (CEO) and leader of innovation and growth in several big Norwegian companies. Has an education within management, economics and trade-sales. Operation experience from tenfolds of boards in early stage ventures.</p> <p><b>Perception of expectation to self:</b> Someone who knew strategy and had experience in the relevant industry.</p>
Case B	<p><b>Education and experience:</b> CEO has worked with business development and entrepreneurship for 22 years. Has an academic background within health and the Norwegian Armed Forces.</p> <p><b>Expectation to outside director:</b> experience from other boards, competence where the management team had neither experience nor competence and contribute both academic and strategic with further development.</p>	<p><b>Education and experience:</b> Has worked as key account manager, chief financial officer (CEO) and leader of innovation and growth in several big Norwegian companies. Has an education within management, economics and trade-sales.</p> <p><b>Perception of expectation to self:</b> Someone who could build long-term structure and culture in the management team on a daily basis.</p>
Case C	<p><b>Education and experience:</b> MSc in computer science. Founded company in 2009 and has been working as CEO since then.</p> <p><b>Expectation to outside director:</b> someone who knew relevant people and would make time to "open some doors". The outside director was appointed because of his industry-relevant experience.</p>	<p><b>Education and experience:</b> Has studied a 2-year program at the Norwegian officer candidate school and has a doctor degree from NTNU. He has 27 years of industry experience as a leader and advisor in the IT and telecommunications industry and has been co-founder of two big IT companies.</p> <p><b>Perception of expectation to self:</b> Someone who is easily accessible and can contribute as a sparring partner.</p>

\*The outside director of company A and company B is the same person.

In two of the case companies (A and C) the outside director had an active role in the company at the time when the interviews were conducted whereas company B was sold in 2010. Further, Table 4.3 lists the education and

experience of the CEOs and outside directors in company A, B and C, the expectations to the outside directors before these were appointed in the companies, and the outside directors' perception of the CEOs expectations to them.

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## 5. FINDINGS

In our findings we present each separate case sequentially with the aim of answering the three research questions. In order to compare the three cases a within analysis is performed on the CEO and the outside director of each separate company, followed by a cross-case analysis of the three companies using the results from the within analysis.

### 5.1 Company A

#### 5.1.1 Resources

##### CEO

The CEO's expressed that the main role of the board of directors was to draw the long lines, think strategically and implement structure. The CEO perceived the outside director as open, honest and transparent and very responsive to signals from the entrepreneurs.

*"He enabled the other party to get to the point faster, made it easier for me to understand what the offer implied, and what was of interest to our venture."-CEO, company A*

The CEO explained that the outside director had the lead role in meetings with investors, and the CEO would supplement with additional information. The reason was that the outside director was familiar with the venture capital industry, and had good at negotiation skills from previous similar process. This was also one of the reasons why the outside director had been appointed as chief of director.

##### Outside director

The outside director emphasized that a professional board was very much related to the way you built structure and culture between people in the management team on a daily basis. In order to build culture and structure the outside director emphasizes the importance of filling the necessary roles not only on the management team, but also on the board. As it is the

chief of director's responsibility to fill the positions on the board the outside director felt it was necessary for him to search his network in order to find persons with the right capabilities and expertise. The outside director further explains that his network is not only used to find competent and experienced people to fill the board, but also in terms of getting in contact with potential investors.

*"When I take the lead role in a meeting, it enables the entrepreneurs to have an objecting function, and stop the process when it strays from their objectives and comfort zone."-Outside director, company A on investor meetings*

According to the outside director it was his job as chief of director to hold the chair at investor meetings. The most important role of the outside director in investor processes was, according to himself, the extensive knowledge about the important role play in these situations. The outside director emphasize that this knowledge has to do with his experience and he expresses that he does not believe that the management team would have come as far without him. A small, but important part of this situation was, according to the outside director, the knowledge of necessary documents, such as non-disclosure agreements, and he believed the investors would probably have been bored with the entrepreneurs pretty soon if he had not been there to help them get through the process.

#### 5.1.2 Legitimacy

##### CEO

The CEO experiences that the outside director's investor relations has helped open some doors and got the entrepreneur team in contact with potential investors. The CEO believes the outside director adds legitimacy to the entrepreneur team since he has been a board member in many other companies, and thus holds a reputation and experience that stake-



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holders appreciates.

### **Outside director**

The outside director explained that in some cases, especially with foreign investors his CV had a legitimating role, as it gave credibility to the management team. However, the outside director specifies that he had to be careful in the way he used his network, not to burn any bridges for future cooperative relationships. The outside director emphasized that it was to a great extent his interaction with the surroundings, among them investor circles, that made investors approach company A. His steady contact with these relations, and his reputation from earlier success gave credibility to the management team in addition to increase the number of approaches from investor circles.

*“What gives the entrepreneur team legitimacy in meetings with investors is my extensive knowledge and experience with acquisitions and exits of ventures, and the knowledge of how the game works.”-Outside director, company A, on legitimating role*

### **5.1.3 Monitoring and control**

#### **CEO**

The outside director was used mostly as a sparring partner in discussions and as an advisor that might shed new light on tough situations, and the CEO emphasized that it was always the entrepreneurs that made the decisions after consulting the outside director. The CEO did not perceive the outside director as a controlling authority, but rather as a supervisor. Further, the CEO did not feel that the outside director would control strategic decisions, but felt that they were coordinated and came to term in an open process, as well described in the below statement.

*“I think we have a shared understanding of how to do business development. We are not very differ-*

*ent” -CEO company A, on the outside director’s control in the company*

### **Outside director**

The outside director explains that what enables him to work strategically with the management team is his ability to speak the entrepreneurs’ language which makes him able to speak strategy without anyone understanding that they are actually talking strategy. In this way he keeps the entrepreneurs on track and talks strategy without the use of theoretical models. The outside director explains that this is because the board has a control function and a strategy function.

*“Some people believe that strategy cannot be implemented very closely in order to sustain the control function, but I do not feel this way myself. ” -Outside director, company A, on control in company A*

The outside director in company A would preferred to work closely with the entrepreneur team to ensure they implemented the strategy, and fully understand his methods. He would rather place an economist beside him to watch carefully and hold the control function. This also allowed the outside director to be less formal. As he explained himself, larger boards would have more power distance and formalities, but this was not the case with company A, which suited the outside director, since he did not see himself as the outdistanced and formal person.

The outside director explained his monitoring of the entrepreneur with what he called a typical Norwegian model where it is important to reach agreements. In this model it was important to the outside director to not express his opinion too quickly, but rather gather different opinions and try to mediate potential conflicts to ensure they come to terms.

*“Norwegian people are preoccupied with being agreeable, but agreeable tactics may not always be applicable in the given situation. ”*

*-Outside director, company A, on control in company A*

Thus, in company A he would vary a bit. Sometimes he would give direct orders, but it always depended on the situation. The outside director expressed that this was something he appreciated with the Norwegian model since Norwegian people were, in his eyes, situational. An important monitoring technique to the outside director was, according to himself, his rational and analytical questioning techniques

that could be used to make people understand his point of view and agree with him. The close relationship with the entrepreneurs enabled the outside director to monitor the entrepreneurs by asking tough questions, expecting timely deliveries.

#### 5.1.4 Within analysis of company A

A comparison of the CEO and the outside director in company A is given in Table 5.4.

**Table 5.4:** *Within analysis company A*

<b>Coding category</b>	<b>CEO company A</b>	<b>Outside director company A</b>
1	Contributes with experience in the entrepreneur team's lacking areas, such as knowledge and advice in how to make a long-term plan, negotiation skills and extensive business experience, and also contributes with knowledge and network within the VC-industry.	Co-opt lacking roles in the management team and on the board. Implements structure and culture. Adds extensive network, especially within investor circles. Knowledge of how to play the investor role game. Provides specific knowledge such as the use of non-disclosure documents.
2	The outside director's reputation in his investor network has helped open some doors to get the entrepreneur team in contact with potential investors, but these meetings is not really of interest to the CEO. The outside director may add legitimacy to the entrepreneur team since he has been a board member in many other companies, and thus holds a reputation and experience that stakeholders appreciates.	His CV and experience gives legitimacy to the entrepreneur team in investor evaluations, especially with foreign investors. His reputation from earlier success gives credibility to the entrepreneur team. His extensive knowledge and experience with acquisitions and exits of ventures gives legitimacy in meetings with investors.
3	The entrepreneur have experienced that the only demand from the outside director is that they stay as an organized and capable business. The entrepreneur feels that the outside director acts more as a mentor or sparring partner rather than as a decision-maker, a supervisor more than a controlling authority, and there has been no disagreements between the two.	Implements structure in the company without the entrepreneurs knowing that this is what he is doing. Works closely with the entrepreneurs and talks their language in order to make a strategy without them knowing this is actually strategy. Uses a typical Norwegian situational model. Sometimes he gives direct orders, other times he would go with more agreeable tactics. Monitors by asking tough questions and demanding timely deliveries.

*\*Within analysis of CEO and outside director in company A. 1 = How can outside directors add scarce resources to a high-growth venture in early stage? 2 = How can outside directors add the needed legitimacy to a high-growth venture in an early stage? 3 = How can outside directors help the board in a high-growth venture to monitor and control their use of resources in an early stage?*

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From the CEO's perspective it seems as if the contribution from the outside director that is valued the most is his advice and knowledge resource that has helped the entrepreneurs manage their daily operations. Although the CEO admits that the outside director's reputation has opened some doors, this is not valued as much by the CEO since they have not been interested in investments yet. In terms of monitoring and control, the CEO did not perceive the outside director as controlling since decisions were made together and they always reached an agreement. Thus the perceived value of the outside director from the CEO's point of view was more of a resource with his knowledge and experience that led to focused discussions.

From the outside director's perspective he added valuable resources to the entrepreneurs by his knowledge, experience and network, but these resources was meaningless if not implemented strategically. Thus the outside director thought his mechanisms of secretly monitoring the entrepreneur was equally important in order to build structure and culture in the company. However, the outside director emphasized that in meetings with investors, especially foreign investors, it was his CV and reputation that was being evaluated, thus his education and experience would play a vital role once the entrepreneurs would go for investment financing.

When comparing the analysis of each row of research questions there seems to be a general mismatch between the outside director's contribution perceived from the CEO's and the outside director's perspective. Whilst the CEO valued the resources the outside director brought to the table in terms of knowledge and advice, the outside director emphasized the importance of his underlying monitoring of the entrepreneur team to ensure that these resources were used strategically and to ensure future growth. The legitimacy the outside director gave the entrepreneur team in terms of CV and reputation seemed to be far more

valued by the outside director than the entrepreneur team, but this seems to be because the outside director was more future-oriented than the entrepreneur.

## 5.2 Company B

### 5.2.1 Resources

#### CEO

*"He asked questions, demanded and challenged us which made us understand that we were going to learn plenty."-CEO, company B*

The CEO expressed that they needed someone with the necessary competence and network, but in addition the outside director needed to be a challenger. The CEO believes this is why they chose the outside director also as their chief of director.

*"He would keep lectures on the different topics we were discussing in order to ensure that we all had a common understanding of things."-CEO, company B*

The CEO expressed that the outside director added skills complementary to the CEO, not only in experience, knowledge and strategic planning, but also within negotiations with potential stakeholders and investors. The CEO felt it was very valuable to have a chief of director that could argue with both facts and numbers, not to mention negotiation skills and communication skills at a far higher level than what the CEO possessed at that stage. A great value to the entrepreneur team was also the coaching he gave them within important areas such as sales and negotiation techniques. She felt that he had an untraditional approach to the outside director role.

*"We had an agreement saying that if I was faced with a challenging decision in meetings with stakeholders, I could always blame any uncertainty on the fact that the control*

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lied with the chief of director, and he needed to be consulted before I could give answer to the question.'-  
*CEO, company B, on negotiation techniques*

All though the outside director did not have the industry specific experience he was concerned with getting the needed competence to the company, and through his network he co-opted another outside director with industry specific competence within marketing, that also had a large relevant network.

#### **Outside director**

The outside director expressed that the entrepreneurs in company B was not very clear in what contribution they expected from him, but his main contribution was related to forming a strategy with the objective of a trade sale exit. Thus, a lot of his time was spent on creating awareness of important factors, such as the revenue, that increases the company value in an acquisition.

*"We used a simple strategy: Increase sales!"-Outside director, company B*

The outside director did not have direct experience within the industry segment that company B was situated in, but he explained that he had experience with forming those types of strategies from other industries, and felt that his competence in that area was highly transferrable. The outside director also emphasized that he was of great help in meetings with potential stakeholders and investors because of his experience with negotiation techniques.

#### **5.2.2 Legitimacy**

##### **CEO**

The CEO had found the outside director through her own network. It was an acquaintance of the CEO that knew the outside director and recommended him to the CEO based on the criteria the CEO was looking for, but the outside director had a lacking relevant network

in the specific industry, thus the CEO usually managed meetings on her own. However, the outside directors were able to co-opt another outside director into the board through his network, and a part to this successful co-optation could be due to the outside director's previous reputation and success. The experience and CV of the outside director was of value to the entrepreneur team, but was never used in meetings with partners.

##### **Outside director**

The outside director expressed that the CEO had more contacts within the relevant industry than himself, thus the outside director could not help add legitimacy any more than the CEO could herself.

#### **5.2.3 Monitoring and control**

##### **CEO**

In company B monitoring and control was according to the CEO ensured through a very close relationship between the CEO and the outside director with very strict requirements for weekly deliveries. As described by the CEO the outside director kept weekly meetings and the CEO was accountable for each number and word spoken.

The CEO explained that the boards control over the management team was a premise for the management team to begin with. According to the CEO the outside director would not allow them to do as they pleased, but take charge of important decisions. The CEO expressed that it was important to the entrepreneurs' that neither them nor any of the owners was part of the board. Still, these principles meant the CEO had to agree to some tough decisions that she might view the same way as the board. Different strategies were discussed in board meetings and the chief of director had the final say.

*"We had an initial agreement saying that should he, one day, no longer think I as capable of doing the job as general manager, then he*

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would tell me, and I would quit.”-  
CEO, *company B*

The CEO considers it a good thing to set these rules when initiating a cooperation. The CEO further describes her relationship to the outside director as very close. They had more board meetings than what was minimum required and according to the CEO the outside director’s role was more of a co-owner. The CEO explains that it was not only the involvement from the outside director, but also some humane similarities between the two of them that made them cooperate so well.

“... It is probably because we share common ethical principles. We do not share the same experiences or education, but we have a very similar base - luminous and similar ethical principles. I appreciate that. I believe it is easier for you to cooperate with someone who shares the same ethical principles as yourself.”-CEO, *company B*

#### **Outside director**

The outside director emphasized that the CEO in company B did not need to be monitored as much as CEOs in previous companies where he had been the chief of director. He explained that the CEO was very competent and had an extremely high implementation capacity. However, an extensive effort was put into monitor-

According to the CEO the outside director’s contribution to obtain limited resources and his monitoring role as a challenger was of high value, but he had no legitimating role to the business. The outside director’s resource-adding role could be compared to the one of a teacher where he trained the entrepreneurs and made them become better at what they were doing. The CEO expressed that the outside director had added value in terms of network, economic knowledge and knowledge within sales and marketing. The CEO valued this knowledge highly because she did not possess

ing the two other entrepreneurs. He had to keep them focused on, not logistics, but sales in order to follow the strategy of increasing the revenue, and hence the value of the company.

“Just tell me how much you have sold since the last meeting, because that is the only contribution I care about.”-*Outside director, company B*

He emphasized how he monitored the entrepreneurs by using questioning techniques, but explained that it was hard to figure out if, or when the entrepreneurs actually disagreed with him. After a while the value of the company was much higher and they were approached by another company that wanted to acquire their business. At that time both the management team and the board had discussed over a period of time that the stage the company was reaching was too demanding for the entrepreneurs in relation to their experience and capabilities, and thus the chief of director decided to consider the offer.

‘... If the price is sufficient, we sell the company.”-*Outside director, company B*

#### **5.2.4 Within analysis company B**

A comparison of the CEO and the outside director in company B is given in Table 5.5.

this knowledge herself. The CEO considered the controlling function of the board as very important to the business, since it let the entrepreneurs execute the daily management operations effectively while the competent board could draw the long lines.

The outside director expressed that his contribution to increasing the sales numbers was his most valuable contribution in company B. Since the CEO was extremely competent his monitoring role became less important and could rather be used at keeping the co-entrepreneurs on track. The outside director

**Table 5.5: Within analysis company B**

Coding category	CEO company B	Outside director company B
1	Extended the team with competence in economics, marketing and sales and an extensive business network. Added guidance and practice and could argue in investor meetings with both facts and numbers. Experienced in negotiation and communication techniques. Coached the team, especially within sales. Used his network to find a new outside director with the needed experience and network.	The main contribution was to form a strategy with the objective of a trade sale exit. He also added negotiating skills to the team in meetings with potential stakeholders and investors.
2	It is questionable if the outside director added legitimacy to the venture since he had a lacking relevant network, however the co-optation of another outside director could have been partly due to his reputation and previous success.	The outside director had no relations in the relevant industry nor any relations to relevant investors nor synergies with his former experience, knowledge or business network.
3	The CEO and the outside director kept a close relationship where the outside director acted as a <i>challenger</i> asking tough questions and with strict requirements for deliveries. The outside director would not allow them to do as they pleased, but took charge of important decisions and ensured progress. Different strategies were discussed in board meetings, where the chief of director had the final say. It was important to the CEO that the board was in control in order to monitor the entrepreneurs since she did not want to keep a two-faced role.	One of his main contributions was to keep the entrepreneurs on track. However, the CEO in company B need not be monitored as much as other companies since the CEO was very competent and had an extremely high implementation capacity. However, extensive effort was put into monitoring the two other entrepreneurs and keep them focused on, not logistics, but sales.

*\*Within analysis of CEO and outside director in company B. 1 = How can outside directors add scarce resources to a high-growth venture in early stage? 2 = How can outside directors add the needed legitimacy to a high-growth venture in an early stage? 3 = How can outside directors help the board in a high-growth venture to monitor and control their use of resources in an early stage?*

did not credit himself with any legitimating role since his former business experience and CV was of no relevance to this particular industry. Instead he pointed out that his real value contribution to venture B was the way he saw things the entrepreneurs were not able to see. This had to do with his experience, knowledge and network and it was the reason the entrepreneurs managed the selling part so well.

The perception of the contribution to limited resources, legitimacy and control appeared very similar from the CEO's and the outside director's perspective. However, there seemed

to be some perception asymmetry between the two. First, the outside director did not think the CEO perceived his contribution to sales as his main contribution, but the findings indicated that the CEO valued this contribution equally much as the outside director. Secondly, the CEO perceived a high level of control from the outside director whilst the outside director expressed that he did not need to monitor the CEO because she was very competent in what she was doing, instead he focused on monitoring the co-entrepreneurs. Added together this indicates a shared understanding of the value contribution, but some differences

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in their perceptions of each other.

### 5.3 Case C

#### 5.3.1 Resources

##### *CEO*

The CEO expressed that the outside director was very passive in the idea/concept stage, especially with regards to the development of strategy. According to the CEO they had worked a total of 5 hours on strategy over a period of 4 years. However, the CEO explained that the outside director's network had been to some help when getting in contact with relevant and strategic people and the outside director has contributed even more in meetings with potential partners.

"I think his restricted contribution in the idea/concept stage is due to a combination of his limited time, and because the outside director was still considering if the venture was worth pursuing." *CEO, Company C*

However, over the past two years the outside directors contribution to the venture has increased, especially in meetings with partners, but the CEO still wished he could have more help with workshops and strategy development. However, the CEO expressed that the contact between the two had become more frequent with more phone calls and even a couple of face-to-face meetings per month. The outside director has begun to use his network more frequently and this is currently being used to acquire a third outside director into the venture.

The CEO perceived the outside director as a supervisor, guiding decisions on choices of direction. He coached the CEO on the investment process, appropriate timing of external funding and the importance of increasing sales. In meetings where the outside director was present the CEO felt that the outside director used his negotiation skills to ensure progress, extract important information and reveal the

true intentions of the other party. In the process of getting external funding, the CEO did not perceive the outside director as value adding.

"I don't think he has been of any value in the process of getting funding to the company, as we have not hooked any investors so far." *-CEO, Company C*

However, the CEO emphasized that the outside director had helped with the screening of investors based on his experience from relationships to investors, and thus saved the entrepreneurs a lot of time.

##### *Outside director*

The outside director expressed that he would give a helping hand when resources were scarce, thus the level of contribution depended a lot on the the activities initiated in the company. The activity level also determined the frequency of contact between the outside director and the CEO.

"On average I have had weekly contact with the CEO." *-Outside director, Company C*

Further, the outside director contributed with his relevant industry experience, where the outside director's most valuable experience was previous initiations and development of firms from the same innovation environment as company C. The outside director also extended the ventures network and thus put them in contact with new potential customers, partners and to some degree investors . In situations where the outside director and the other party had a mutual trustworthy history the lead on the contact was kept by the outside director for 'a long time". The outside director characterized the relations in the network as businesslike and open.

The strategy was formed based on sparring sessions at board meetings, and the outside director helped the entrepreneur prioritize and make decisions.

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“Together we formed the strategy with an “outside-in” and “inside-out” perspective on the venture.”-  
*Outside director, Company C*

The outside director further inhibited time-consuming pursuits of unrewarding opportunities and, more specifically, expressed that a valuable contribution to the CEO was hindering the CEO from getting in contact with relations whom the outside director did not find trustworthy. The outside director also coached the CEO on what type of information he should, and should not, disclose.

In meetings with stakeholders the CEO would hold the chair whilst the outside director would take a secondary and complementing role, adjusting the direction of the discussion if needed (e.g. tried to determine if there was a foundation for partnership early in the discussion, so the other party did not receive unnecessary information about the technology). The outside director further contributed with experience from negotiations from tendering projects and processes and merger and acquisition of companies.

### 5.3.2 Legitimacy

#### *CEO*

The CEO perceived the outside directors as a “door opener” to strategically important partners to whom the outside director had close relations. Thus the outside director made it easier to create connections to parties that otherwise would not have considered the entrepreneur as credible. The CEO also noticed that the reputation of the outside director played an important role in investor meetings. To begin with the CEO explained that the legitimating role of the outside director was more on paper in order to embellish the company and the more outside directors on the board, the better.

“It is equally important to have several external directors, especially in

order to brag a little.” -*CEO, Company C*

#### *Outside director*

The outside director perceived that the professional perception of the venture was strengthened by his presence. In addition it increased the perceived trustworthiness of company C from other parties to whom the outside director had a close relation. When asked what his perception of a professional board was, the outside director answered that a professional board to him was a board able to understand the framework by which the company is working (i.e. market, technology, funding and partners), but also a board that can contribute to govern the company in the right direction.

### 5.3.3 Monitoring and control

#### *CEO*

In situations where the board and the CEO disagreed on directions, the CEO had so far been allowed to try and see if it panned out. However, the board would give the CEO a limited amount of time to pursue this direction and, if it did not add any value, they would shut the project down.

“Lets try, even if the board disagrees. At worst it goes to hell.”-  
*CEO, Company C*

#### *Outside director*

The role as an outside director was perceived more as an ongoing sparring process than a typical controlling role, and decisions among the CEO and board of directors were mainly based on consensus. The outside director also found that frequent contact and sparring sessions enabled insight to the entrepreneur’s many and simultaneously run processes. Thus the outside director was able to structure the entrepreneurs’ many desired directions of action. Still, the outside director felt there was a need for increased structure in terms of more frequent board meetings and increased monitoring of the established strategy and objectives.



“Concerning strategy I believe the CEO has full control. I believe that the CEO... or the board... could have become even more structured by holding more frequent board meetings and more reports. Thus I believe structure is improvable in terms of more rhythm in order to

define what should be presented at board meetings and more frequent follow-up on established plans.”-  
*Outside director, Company C*

### 5.3.4 Within analysis of company C

A comparison of the CEO and the outside director in company C is given in Table 5.6.

**Table 5.6:** *Within analysis case C*

Coding category	CEO company C	Outside director company C
1	Except from adding network, there was no or limited contribution to scarce resources in the idea/concept stage and little contact with the outside director. Resource-adding has increased over the past two years with added industry knowledge and experience, participation in meetings and network. The CEO wish the outside director would contribute more and perceives no value added from the outside director in getting external funding.	The outside director’s contribution depends on the activities initiated in the company and he perceives the sparring activities between him and the CEO to have been frequent and steady since day one. Contributes with industry experience, network extension, relevant knowledge and advice, coaching, negotiation experience and investor relevant knowledge.
2	The CEO believes the reputation of the outside director was the most important contribution to the company to begin with. The outside director has later acted as a “door opener” towards strategic partners. His relationship to investors give credibility in meetings.	The outside director’s relationship and reputation in investor meetings give credibility to the team and the venture appears more professional.
3	The CEO influences the control of the board. If there is a disagreement the CEO is given a limited time period pursue the “project” before it is shut down.	Decisions between the CEO and the board are made with consensus. The outside director sees his role more as a sparring partner. There is a need for increased monitoring of established strategy and objectives.

*\*Within analysis of CEO and outside director in company C. 1 = How can outside directors add scarce resources to a high-growth venture in early stage? 2 = How can outside directors add the needed legitimacy to a high-growth venture in an early stage? 3 = How can outside directors help the board in a high-growth venture to monitor and control their use of resources in an early stage?*

From the CEO’s perspective it seems as if the most valuable role of the outside director to begin with has been to boost the credibility of the venture on paper, thus the CEO has experienced that even though the outside director had a passive role to begin with, this added legitimacy to the venture. The CEO has perceived an increased contribution from the outside director over the past years, mostly

within network, advice and knowledge from his industry-experience, but also in terms of participation in meetings with partners and investors. The CEO perceives no added value as to getting external funding since no funding has been obtained yet. When it comes to monitoring and control the CEO does not portray the outside director as controlling, but emphasizes that it is he, the CEO, that is in

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charge of most decisions whilst the outside director adds advice along the way.

From the outside director's perspective it seems as if he has contributed equally much from day one, but in contrast to the entrepreneur the outside director describes his contributions as situational. While the outside director values his contribution within network and industry knowledge and experience, he highly emphasized his own contribution to investor and partner meetings and explains that his value to these meetings is not only the legitimacy he can provide, but also his negotiation experience and investor relevant knowledge. The outside director expressed that his role is more of a sparring partner and that decisions between the CEO and the board are made with consensus. Still, the outside director emphasizes a need for increased monitoring of established strategy and objectives.

When comparing the two there seems to be a general misperception of the outside directors longitudinal contribution. The legitimacy seems to be valued more on paper from the CEO's perspective while the outside director's emphasizes his active legitimating role in strategic meetings. They both seem to have an equal perception of the status of control and monitoring in the venture, but they both express a need for change. The CEO would like more help from the outside director and the outside director sees a need for more monitoring and control of the strategic plans.

## 6. CROSS-CASE COMPARISON AND DISCUSSION

A cross-case comparison of the within analysis of company A, B and C is given in Table 6.7. When comparing the three cases it seems as if there are both differences and equalities as to the CEO's and the outside director's perception of the contribution from the outside director. Of the three companies the perceptions of the CEO and the outside director were most aligned in company B. Company C seems

to be the company where the outside director had contributed the least in the long run. The perception of the outside director's role seemed to differ the most between the CEO and outside director in company A. All CEOs acknowledged the importance of obtaining scarce resources, legitimacy and monitor and control of these resources at an early stage, but the CEOs differed as to what extent the outside directors could contribute in these areas.

### 6.1 How can outside directors add scarce resources to a high-growth venture in early stage?

Our findings show that one of the contributions from the outside directors that is emphasized the most by the CEOs is their *organizational resources* as suggested in the resource-based theory. In our case *organizational resources* refer to the outside director's know-how related to how ventures operate, board experience and strategic management. These organizational resources seemed to help leverage the case companies internal strengths as well formulated in the statements below.

"We tried to find an external person who could help us see the bigger picture, because you are not able to see the big picture when you work in the company with the daily management. It gets too close." -CEO company A

"When they come to me it is strategy and structure they want. ... we never use the word strategy, but it is what they want." -Outside director, company A

The reason why the CEO in company A did not use the words structure and strategy when describing their needs may be due to several causes. The CEO may not know the needs of the business or otherwise, the CEO may not share the academic language of the outside director that enables him to talk in business terms, or perhaps both reasons combined.

**Table 6.7:** *Cross-case analysis*

Coding category	Company A	Company B	Company C
1	Both perceives that the outside director contributes with knowledge and advice within strategy, negotiation skills, and business experience. However, outside director also points to a broadened network especially within investment circles.	Both expressed that the outside director provided competence and coaching within economics, marketing, sales, and negotiation skills. In addition the CEO highlighted the importance of the co-optation of a new outside director.	Both perceives the outside directors to contribute with industry knowledge and experience, negotiation techniques and extended network, however there is a general mismatch in the scope and value of the longitudinal contribution.
2	Both express that stakeholders appreciates the outside director's reputation and experience. However the outside director values his legitimating role far more than the CEO and express that his extensive knowledge and experience with acquisitions and exits increase the legitimacy.	Both have a shared understanding of the limited legitimacy provided by the outside director.	Legitimacy valued more on paper from the CEO's perspective whilst the outside director emphasizes his active legitimating role.
3	Both perceives the outside director as a sparring partner, and supervisor. However, the outside director emphasized the importance of his contribution to underlying control, implemented through a common language, close contact, and using a typical Norwegian situational model.	The CEO perceived a high level of control from the outside director whilst the outside director expressed he did not need to monitor the CEO since she was extremely competent. However the outside director had to keep track of the other entrepreneurs and did so by using question techniques about deliverables.	Both agree that decisions are made with consensus, and perceives the outside director's role as more of a sparring partner. However, the outside director expresses a need for increased monitoring of established strategy and objectives.

*\*Within analysis of CEO and outside director in company C. 1 = How can outside directors add scarce resources to a high-growth venture in early stage? 2 = How can outside directors add the needed legitimacy to a high-growth venture in an early stage? 3 = How can outside directors help the board in a high-growth venture to monitor and control their use of resources in an early stage?*

As the outside director explains, they both share the same perception of needs, but they need to use the entrepreneur's language in order to convey the message. This corresponds to how the model, suggested by Hernandez [2012], describes cognitive behavior as one important antecedent for stewardship behavior. Thus the outside director may add to scarce organizational resources, but it seems equally important that these resources are conveyed in a manner that enables the entrepreneur to

understand and manage the resources.

The ability to convey the academic language into a language the CEO understands can be seen as a way of using the outside director's *human resources* to convey *organizational resources* into a language understood by the CEO. The general finding in all cases was that the outside directors had all contributed with *human resources* consistent with a resource-based view, in terms of how they coached the entrepreneurs, contributed with industry-

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specific knowledge, negotiation experience and education. Another human resource was the outside directors' knowledge of 'how the investor game works' in terms of how the different know-hows could be balanced and used strategically together in investor meetings. In company A and company B our findings imply that the outside director worked very close to the CEO. The frequent coaching, workshops and facilitating indicates that the role of the outside director took a more hands on approach. However, in company C the outside director did not keep such a close relationship with the CEO, but still contributed with industry expertise and advice when needed. Considering the outside director's background and competence in company C it might also be that he has a better ability to contribute to the scarce resources at a more mature level, underscoring, from a resource-based view, the importance of the outside directors relevant competence and personal qualifications, in order to provide a competitive advantage [Gabrielsson and Huse, 2005]. As both the CEO and outside director expresses a need for change this might as well imply that company C is moving into a new stage where the company needs a new strategy and other kinds of resources. The CEO perceived the reason for the lack in contribution to mainly concern motivational issues:

"(about the outside director) ... it was still a very early phase so he probably didn't know if he should spend time on the business or not. He didn't know if we would succeed or not, how well things would go and who we were..." -CEO, company C

This statement indicates that the contribution from the outside director might be situational and dependent upon the stage of the company. As the outside director expresses:

"My contribution has depended on the activities initiated in the company." -Outside director, company C

In the beginning he had contributed with advice through phone calls, but lately he had participated more in investor and partner meetings, thus it might be that company C had reached a stage where the outside director felt he could contribute more, while company A and company B had already reached this stage when their outside directors were initially appointed. In each case the outside director had also contributed in acquiring resources to the boards in order to mitigate the management teams resource lack. This is consistent with how the resource dependence view describes the combination of the outside directors extended network and their ability to co-opt new strategically important board members is associated with decreasing the company's dependency on its surroundings.

It is interesting that both the CEO and outside director in company C express a need for more cooperation, thus the remaining question is why there has not been a change when both parties feel a need for change. Seeing as the CEO in company C has not exchanged his outside director with someone else, this implies that he has received some valuable contribution from the outside director. Thus in this case it might have been the outside director's *social capital* that created value in the company.

Our findings show that the outside director contributed with social capital consistent with the resource-based view in terms of how the director's network extensions may add a wider network of relevant contacts to the entrepreneurs' present network. The outside directors description of their interaction with the surroundings in order to open doors and to acquire relevant resources to the management team are examples of how the outside director *connects the entrepreneur to its surroundings, co-opts from surroundings and gives credibility to the entrepreneur* as consistent with a resource-dependent view. As described by the outside directors it is their job to open doors, but it is the entrepreneur that needs to take actions, thus emphasizing the importance of how outside directors convey strategies to the entrepreneur and make sure these strategies

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are understood.

The overall findings on scarce resources added by the outside directors have led us to suggest the following proposition:

**Proposition I:** *What enables the entrepreneur to take advantage of resources obtained from outside directors depends upon the outside director's ability to convey knowledge into a language the CEO understands.*

## 6.2 How can outside directors add the needed legitimacy to a high-growth venture in an early stage?

The CEOs in the three companies perceived added legitimacy from the outside directors in terms of reputation and relationship to investors consistent with the resource-dependence view. To company A and company C the outside director's active legitimating role became most apparent in investor meetings where the bond and shared knowledge between the outside director and investor were perceived as essential to the outcome of the meeting. However, as expressed by the outside director in company A and B, his education and experience was very important when in contact with foreign investors, thus the type of legitimacy added may vary with different types of investors.

In company C there also seemed to be a perceptual incongruence between the two parties that might have occurred for several reasons. First, as previously described, the language between the CEO and the outside director may not be compatible and thus lead to a misunderstanding of the perceived contribution. Further, it could be that the outside director was intentionally holding back his network due to the high level of uncertainty associated with the firm considering that he came into the company at a concept/idea phase. Thus, from a resource dependence view, indicating the outside directors awareness of the importance that he not only establish relations, but also build trust-

worthy relations, through legitimacy, in order to link the company to potential stakeholders, and reduce environmental uncertainty (Pfeffer [1972]; Salancik and Pfeffer [1978]; Gabriellsson and Huse [2005]).

The CEO and outside director in company B did not perceive any legitimacy from the outside director since he had no relevant relationships to investors in the industry, which indicates that the relationship towards investors was seen as most important in terms of legitimacy. However, the outside director in company C also emphasized that his know-how in investor meetings made the entrepreneurs appear more professional, which may imply that the outside director may be able to add legitimacy through his 'hands-on' role in the venture even in situations where neither the outside director nor the CEO had a direct relationship to the investor. The CEO in company C expressed that in the initial phase of the venture it was most important to be able to show to an outside director on the board in order to brag in terms of eminent board members. This could be a way for company C to signal its superiority to other entrepreneurial firms and may indicate that the outside director could have different kinds of legitimating roles in the companies and, as suggested by the CEO in company C, the legitimating role may vary with the stage of the company.

**Proposition II:** *The outside director's legitimating role is situational and varies with the stage of the company.*

## 6.3 How can outside directors help the board in a high-growth venture to monitor and control their use of resources in an early stage?

The degree of monitoring and control by the outside director seemed to differ in the three companies and it is interesting to observe that company B, where the outside director is given full control by the CEO, is the company where

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the outside director feels the least need for control. As Davis et al. [1997] described the problem is usually not entrepreneurial motivation, but to what extent the entrepreneurs can achieve a good venture performance and it seems as if the outside director in company B believes in the CEOs implementation capacity and they seem to have a shared understanding consistent with Stewardship theory as clearly formulated in the below statement.

“... It is probably because we share common ethical principles. We do not share the same experiences or education, but we have a very similar base - luminous and similar ethical principles. I appreciate that. I believe it is easier for you to cooperate with someone who shares the same ethical principles as yourself.”-CEO company B

This is in accordance with Davis et al. [1997] who suggest that there is no goal incongruence in early ventures where the entrepreneur holds the position as both manager and owner. Thus the outside director's contribution in company B was to make the strategy, but there was no need to monitor the extremely competent CEO, thus he instead needed to monitor the co-entrepreneurs of company B. In this way the outside director seemed to take on a more 'hands-on' approach where he had collective lessons teaching the entrepreneurs how to perform sales. As this was a way for the outside director to assure that they were working towards a common goal to increase sales it is very similar to how Hernandez [2012] describes how promoting the 'employees' collective responsibilities for work outcomes as a structural factor fostering stewardship behavior. The outside director expressed that he enjoyed working closely to the entrepreneurs and explained that it was not always enough to give direct orders as indicated in the statement below.

“I am good at making people agree with me, but do they really agree?”

I am not so sure...”-Outside director, company B

This indicates the presence of stewardship behavior where the entrepreneur believe he/she is morally obliged to pursue the shared interests with the outside director (Caldwell et al. (2000), as cited in Hernandez [2012]). Thus the close cooperation to the entrepreneurs may be a way for the outside director to ensure that there actually is goal congruence between them. The CEOs in both company A and company B picture their outside director as expecting high demands and timely deliveries, and they both indicate a goal congruence between themselves and the outside director. This indicates that the relationship between the CEOs and the outside director in company A and B seem to follow a stewardship model, where the CEOs act as stewards who's motives are aligned with the outside director (Davis et al. [1997]; Hernandez [2012]). However, the way the outside director in company A and B expressed that he sometimes needed to give direct orders, demand timely deliveries and keep control of financials suggested that his role sometimes took on a more agency approach, thus the monitoring role of the outside director seemed to vary somehow between agency and stewardship monitoring dependent on the situation and stage in the company.

The outside director and the CEO in company A seem to have a good relationship where the main focus was the development of the company. The CEO did not feel that the outside director overruled in strategic decisions, but that they were coordinated and came to terms in an open process, as clearly illustrated in the below statement.

“I think we have a shared understanding of how to do business development. We are not very different” -CEO company A about the outside director.

The outside director in company A explained that his way of monitoring used the typical Norwegian agreeable model and he

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explained that by using the entrepreneur's language they usually managed to come to terms. This emphasized the importance of the outside director's human capabilities to his monitoring role. The outside director seemed very aware of the negative implications of using academic models to model strategy in company A and expressed that this would not please the entrepreneurs. This is interesting considering that the CEO both held the role as owner and board member in company A. Thus the role of the outside director was to please the owner at the same time as he should monitor the strategy for the company's resources.

In company C the monitoring and control by the outside director was somewhat different from company A and B. This might be because the CEO held the position as chief of director in company C while the outside director held the position as chief of director in company A and B, thus according to an agency perspective the entrepreneur in this case held the position as both principal and agent. In company C both the CEO and outside director expressed that decisions were usually made with consensus and the CEO is very clear about his need for their opinions as stated below.

"... we agree on most things and they (the board) believe I manage very well without them, thus I in reality I do a lot on my own."-CEO company C

Still, the CEO emphasized that he wished he could have more help from the board in dealing with strategy, which may indicate that the CEO wanted the board to take on a more monitoring role. However, a prerequisite for more board control would probably imply that the CEO would have to give up some control and according to agency theory one of the most important aspects when giving up control is overcoming the potential information asymmetry. There appeared to be some information asymmetry between the CEO and the outside director of company C as to how much time the outside director has spent on helping the

CEO in the initial phase. This might be because the activities in the company has changed or it might be a consequence of the CEO becoming better at listening to the opinions of the board. As the outside director in company C expresses a need for increased monitoring of established strategy and objectives compared to before, it seems as if the company is going through a change that may set new requirements to how the monitoring and control of the company is being performed.

Our discussion indicates that the monitoring and controlling role of the outside directors might be situational and dependent on the stage of the venture. The relationship seems to be driven by frequent mutual social exchanges between the outside directors and the CEOs, long-term strategy planning and affective relationship-centered collaboration, which has led to the suggestion of the following proposition:

**Proposition III:** *Outside directors in early stage entrepreneurial ventures monitor and control the company by fostering stewardship behavior.*

#### **6.4 The correlation between resource-adding, legitimacy and monitoring and control**

The outside directors contribution to resources may be situational and dependent on the stage of the venture. Our discussion suggests that from a resource dependence view the outside directors may add scarce resources and increase the competitive advantage by strengthening the venture's internal resources. From a resource dependence view the outside directors may procure external resources and increase the competitive advantage through co-optation and legitimacy. However, it seems to be the outside director's monitoring ability to exploit opportunities and combine internal and external resources by exercising leadership, promote learning and increase synergies, within the venture and between the venture

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and its surroundings, that creates an inimitable competitive advantage.

## 7. CONCLUSION

Our findings show that the outside directors may contribute to scarce resources by adding *organizational, human and social* resources consistent with the resource based view, and also increase the ventures interaction with its surroundings by co-optation and added legitimacy in accordance with the resource dependence view. However, what enables the entrepreneur to take advantage of resources obtained from outside directors seems to depend upon the outside director's ability to convey knowledge into a language the CEO understands. Our findings suggest that the outside directors may add legitimacy by their *reputation, CV, experience and trustworthy relationships* and the legitimating role seemed to be situational and vary with the stage of the company. The outside directors seemed to help the ventures with their monitoring and control of resources by *strategically combining internal and external resources and fostering stewardship behavior*. Our findings indicate that the value-adding role of the outside director to these high-growth ventures in the early-stage may depend upon the stage of the company and of the extent of the outside director's activity in the firm.

## 8. EMPIRICAL CONTRIBUTION

Our case study contribute to insights in the use of outside directors, an area where there has been none, or limited, research up till now. The authors facilitate a greater explanatory power to how outside directors may strengthen high-growth ventures at an early stage by fostering stewardship behavior and strategically combining internal and external resources in order to obtain competitive advantage, and suggest some interesting implications for future research.

## 9. IMPLICATION FOR THE ENTREPRENEUR

Our findings suggest that the entrepreneur should strategically seek to acquire outside directors who possess a knowledge and competence that is complementary to the management team in order to strengthen internal resources and leverage the competitive advantage of the venture. As the outside director may add legitimacy to the venture through his/hers reputation, CV, former experience and trustworthy relationships, the entrepreneur ought to perform a due diligence on the outside director in order to evaluate the potential for obtaining legitimacy. As our findings suggest that outside directors may foster stewardship behavior through close cooperation with the CEO, the entrepreneur should ensure that the outside director's expectation to contribution is aligned with the entrepreneur's own expectations as to make sure that the outside director actually takes his time to work with the entrepreneur. Our findings suggest that the resource advantage might depend upon the outside director's ability to convey his/hers resources in a way that enables the entrepreneur to understand. Thus the entrepreneur should seek to acquire an outside director to whom the entrepreneur experience a shared understanding.

## 10. IMPLICATION FOR FURTHER RESEARCH

Our findings suggest that more research should be conducted on the value-adding role of outside directors to high-growth entrepreneurial firms, as most literature written about outside directors concern larger companies and because the studies and implications of high-growth entrepreneurial firms may differ significantly from other studies dealing with SMEs. In addition there has been very little qualitative research in this area, thus there is a further need for explorative research within this field. We further suggest that the outside director's value-adding role in high-growth



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ventures at an early stage should be further investigated in terms of stage theory, since this theory acknowledges the importance of research within all stages in a venture due to the different needs of resources at different stages. We further suggest that our three propositions should be further investigated in terms of qualitative case studies that enables more explorative research on the phenomenons.

## 11. LIMITATIONS

Despite the discussed benefits that come from applying a case study method, this research method also comes with several challenges. There is a *problem of complexity* related to the embeddedness of the different CEOs and outside directors in a wider network and each actor's relations and dependence on factors such as political, technological, spatial, social and market structures. Such a network dependency can be hard to detect, especially because it is very difficult to describe a network due to the limited absorptive capacity of each party.

There is also a *problem of time* associated with change. Easton ((1995), p. 419, as cited in Halinen and Törnroos [2005]) posit that "the unit of analysis is, by its very nature, dynamic and susceptible to change". As the potential role of the outside directors can be considered a change process, then the whole range of longitudinal methods and tools used for process research should be considered. In order to provide sufficient descriptions and explanations of the processes, the time concept should be incorporated consistently into the research. Time in this case could also relate to the maturity of the venture, and since this article considers ventures in the early stage, the constraints of cases have been high-growth entrepreneurial ventures that have obtained outside directors in the early stage. Because we have studied the strengthening role of outside directors in this paper, a social aspect, we have not considered aspects such as political, technological and economic factors. Thus our theoretical perspective may have lost some of the complexity of the outside directors in real-life situations.

In this article there is also a problem associated with each case's unique history and context. Besides, this study is based on sampling of three Norwegian companies seeking investments, thus the results are hardly statistically significant. Due to a small geographical focus and a limited number of cases these results cannot be regarded as generalizable to the general population of entrepreneurial ventures and outside directors in the early stage. Although we took steps to minimize bias from informants, we cannot be sure that we were fed subjective portrayals of accounts due to the close relationships between the outside director and entrepreneur that might have influenced the data obtained.

In addition, all interviews and transcriptions were conducted in Norwegian and have later been translated into English, thus there might be limitations to the reproduction of data. However, the authors have ensured that the meanings of quotes are as explicit in English as it is in Norwegian.

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# Exploring how to develop investment readiness to bridge the financing gap and become seed level investor ready

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## Abstract

*High growth technology based firms are important for economical development and in order to increase the supply of these firms, the failure in the market for early stage equity supply need to be addressed. Investment readiness have been developed as a concept for assessing whether a venture would be ready for equity finance. However, the concept is poorly defined and lack the entrepreneur's perspective, lacking a foundation to explain how investment readiness could be developed, and how it relates to the life cycle of the venture. In this paper we derive a holistic model giving a continuous and dynamic understanding of investment readiness, containing investor ready levels, related to the venture's life cycle. By exploring two seed stage Norwegian ventures seeking finance we derived an empirical tested model that explain how information asymmetry and uncertainty affect investment readiness, and how entrepreneurs use social network ties in order overcome these challenges, effectively providing a 'social' bridge to the financing gap in the seed stage.*

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## 1. INTRODUCTION

High growth technology based firms is a major contribution to economical development and source of new employment (Shane [2009] and Shane and Cable [2002]). As young entrepreneurs often are whelth constrained ([Sætre, 2003]) it is recognized that while seeking to exploit significant growth opportunities these firms need to access appropriate forms of finance in order to realize their potential [Mason and Kwok, 2010]. These firms need to invest heavily in the business in order to start generating revenues, and positive returns are expected only after a number of years. The faster the growth and exploitation of the opportunity, the more voracious is the appetite for cash [Mason and Kwok, 2010]. For ventures seeking to exploit significant growth opportunities without the ability to fund the growth from internal generated sources, external equity funding might be the only source of capital. However, in order to acquire equity funding the entrepreneur need to find and convince an investor to invest in the venture.

While it is widely known that it is important for such ventures to get venture capital, there is little knowledge of the challenges facing these entrepreneurs in acquiring it. In addition there is a widely recognized market failure in the supply of early stage venture capital (e.g. [Mason and Kwok, 2010], Mason and Harrison [2004], and Mason and Harrison [2001]). Especially there is a shortage of venture capital supply in the seed, start-up and early growth stages of venture development (e.g. Aernoudt [2005] and Mason and Kwok [2010]). There are several numbers of reasons for this, e.g. inability to overcome information asymmetries, investors perceive the risk higher in the early stages because management team is inexperienced and has gaps, and the market and product is unproven [Mason and Harrison, 2004]. However, according to Mason and Harrison [2004] there is considerable evidence suggesting that investors have considerable funds available for investing, but decline proposals because of two main demand-side

weaknesses, namely; 1) *a high level of equity aversion amongst the ventures* and 2) *a low degree of investment readiness among the ventures seeking capital*. However, Mason and Kwok [2010] and Mason and Harrison [2001] argues that investment readiness incorporates both aspects, in addition to presentation failings. The concept has mainly been studied from a supply side perspective and lacks a holistic and comprehensive definition. Hence, while the demand side weakness is argued to be caused by lack of *investment readiness*, Mason and Harrison [2000] argues that the concept in itself need to be defined and understood in much more detail.

One particular weakness of investment readiness is that it lacks a entrepreneur's perspective, which limits the understanding of both the concept and why it leads to the market failing. Mason and Harrison [2000] states that entrepreneur's need to identify and plan for the most appropriate financial and ownership structure for business early, as it is critical to the potential future success of the business. Which essentially means identify and plan for *investment readiness*. However, Mason and Kwok [2010] argues that entrepreneur's lack information and advise on the advantages of raising equity, what it means to be *investment ready*, and how to become *investment ready*. Hence, they need advise and support in order to be able to enable this strategy, as (HM Treasury/Small Business Report Service, as cited in Mason and Harrison [2000]) argues that lack of knowledge, exacerbated by equity aversion prevent ventures from reaching it's potential. It is apparent that both advisors and investors would benefit from understanding *investment readiness* from the entrepreneur's perspective.

According to Sapienza and Korsgaard [1996] some of the most difficult challenges the entrepreneur has to face is financing the on-going activities and anticipating the timing in advance of when the infusion of capital is needed [Sapienza and Korsgaard, 1996]. Anticipating the right timing implies knowing when the venture will be ready for external equity investment (Sapienza and Korsgaard

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[1996]), effectively benchmarking investors' criteria against the future readiness of the venture in assessing when the venture are eligible of getting infusion of investor funding. External investors understand the risk involved in funding such companies, and may add value by bringing their experience to the team, and give access to extensive network of buyers, suppliers, and possible joint venture partners (Mason [2005], Douglas and Sheapher [2002] and De Clercq et al. [2006]).

For an entrepreneurial CEO the issue of knowing when the venture is ready for investment is a complex and multivariable problem to handle, where both internal and external information asymmetry, uncertainty and knowledge asymmetry increases the complexity. It is apparent that growth seeking ventures may have huge benefits from getting an investor on board in helping them reaching their goals. Despite of information asymmetries and uncertainty in seed stage of development (Sørheim et al. [2011]; Lahti [2012]), many ventures successfully obtain funding even when technology and business concept are undeveloped (Shane and Cable [2002]; De Clercq et al. [2006]). Hence, there is a need to investigate how entrepreneurs obtain funding to exploit opportunities (Shane and Cable [2002]), essentially exploring how they plan and execute, effectively coping with information asymmetry and uncertainty, in order to become *investor ready*. More specifically, we take a demand side perspective of investment readiness, and explore how entrepreneur's develop investment readiness in order to become investor ready throughout the life cycle of the venture.

The aim of this paper is thus to develop a more holistic and comprehensive model for investment readiness, contributing with insights from the entrepreneur's perspective, throughout the venture's stages of development. By exploring investment readiness from the entrepreneur's perspective our goal is to better the understanding of the entrepreneur's challenges. We believe that mutual understanding is a basis for every successful relationship, and hope that a more balanced perspective on in-

vestment readiness could contribute to this. We will contribute by building on existing theory and propose a holistic model of investment readiness, where the challenges of information asymmetry and uncertainty are presented and related to the model, throughout the life cycle of the venture. We will further suggest an explanation on how the entrepreneur cope and overcome these challenges in order to plan and become investor ready when the infusion of funding is needed.

Hence, the model will contribute on how entrepreneurs can develop its investment readiness to reach levels of investor readiness along the venture's stages of development. However, focusing on the financing gap in early stage of development, we will use a case study to investigate how entrepreneur's can develop investor readiness to become investor ready for early stage equity investment. This will be done by conducting explorative case interviews and workshops with two early stage high-technology Norwegian start-ups seeking investment. We want to investigate the following main questions;

1. *How do entrepreneur's plan and develop investment readiness to become investor ready?*
2. *How do entrepreneurs cope with information asymmetry and uncertainty in the process of becoming investor ready?*

Crucial areas to cover will therefore be how investment readiness relates to the entrepreneur-Investor relationship, types of investors, and pre-investment activities. In addition develop an understanding of the relation between investor ready and investment readiness, challenges posed by information asymmetry and uncertainty, and how social networks could provide solutions to overcome these challenges.

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## 2. RESEARCH METHOD

### 2.1 A theory-building case study research design

In this paper our objective is not only to test the explanatory power of investment readiness in specific cases, but inductively explore build on the theory, as it needs to be defined and understood in much more detail (Mason and Harrison [2000]). In order to build a theoretical model of investment readiness, that could be able to describe the causal interrelations of the different challenges the entrepreneur faces when seeking to obtain equity finance, we have employed a case study research design. Yin [1989] defines a case study as ‘an empirical inquiry that investigates a contemporary phenomenon within its real-life context when the boundaries between phenomenon and context are not clearly evident and in which multiple sources of evidence are used’ (Yin [1989], p. 23) and Eisenhardt [1989] has emphasized the potential of case studies to capture the dynamics of the studied phenomenon. Thus, it is a well-known research method for exploratory and theory-building research (Eisenhardt [1989]).

One could say that the author’s started out inductively in what Eisenhardt [1989] calls the ‘*traditional*’ approach, as the first definition of the research questions and initial theory was developed by combining observations from previous literature, our common sense and experience as entrepreneurs. However, it had an actual tie to empirical data as one of the authors worked, both as a entrepreneurial CEO of an early stage venture his co-founding and as an informal advisor to another early stage venture seeking to obtain the first round of funding. Hence, the research was started with a solid and intimate grounding in empirical reality that according to Glaser and Strauss (1967) (as cited in Eisenhardt [1989]) permits the development of a testable, relevant, and valid theory.

Through the initial stages we asked ourselves how investment readiness was related to being able to get the right investor at the

right time in the development of the venture. Hence, we set out to build a model of investment readiness that would describe the causal interrelations of the factors affecting the ability of the venture to become ready for equity investor funding.

### 2.2 Developing a new model for investment readiness

In developing an holistic theoretical model our approach was inspired by *grounded theory*, in that the theory have been grounded in data and evolved through a continuous interplay between data collection and analysis Strauss and Corbin [1994]. After initially starting with the direction as mentioned above, we used existing literature on investor readiness, investment readiness, market failure in the supply of early stage equity, the entrepreneurs challenges, and pre-investment process to give direction of the data collection. Keeping the concepts the basic unit of analysis we followed the procedure proposed by Strauss and Corbin [1990], by codifying the collected data into suitable interrelated categories describing the challenges facing the entrepreneur in acquiring early stage equity funding.

Throughout the iterative process of data collection and analysis working hypothesis about the relation between the categories where developed and verified. The process of investment readiness was the main concept of analysis in the cases, and was built into the theory interrelated with other major concepts that evolved through the process, and proposed as a theoretical model for investment readiness (as shown in Appendix B).

Further this model was presented in workshops, where all hypothesis of related categories where systematically tested and selectively coded against investment readiness for analysis. Hence, providing a basis for redefining the theoretical concept of investment readiness, its relation to investor ready, development of ventures, the challenges faced by information asymmetry and uncertainty, and solutions proposed by social network theory. Further,

the selective coding and analysis of the workshops lead to a new empirically derived model where the evolved important concepts are systematically related, as presented in section 4.

### 2.3 Theory-driven case selection

Consistent with Eisenhardt [1989]’s advise on selecting cases for theory building, we have strategically selected two cases in order to be able to replicate and extend the theory of investment readiness, focusing on how to become investor ready. Especially relevant since both are in early stage of development, as concepts of investor ready has been focused on discussions on the failure in the supply of early stage equity. Both case venture’s selected are high-technology growth oriented start-ups that can be categorized as being in the seed stage of development (using e.g. De Clercq et al. [2006]), and seeking to fund the development of their ventures. As both face the challenges of planning and executing in order to become investor ready, we argue that they provide invaluable empirical data intimately connected to the demand-side weaknesses proposed as a reason for failure in the supply of early stage equity finance.

The case ventures are similar in that they where founded by first time entrepreneurs, studying in the same graduating class at NTNUs School of Entrepreneurship, where both started with a conceptual idea approximately a 1.5 year ago. Both companies also have and industrial market for their products, which put some limitations on the study as consumer market companies are not represented. One

difference may be that customer in for companies in B2B market may also be potential industrial investors. Another limitation to the case selection is that neither of the ventures have received traditional investor funding, effectively not providing us with two polarized cases in terms of success [Eisenhardt, 1989]. However, one case company have acquired a pre-seed investor with extensive experience in raising equity funding. The other has had meetings with potential seed stage investors during our research, which might be optimal in addressing the issues of investment readiness from the entrepreneurs perspective.

### 2.4 Data collection

The data consists of in-depth mapping interviews the CEO and CFO in Company A, and The CFO in Company B, and an in-depth interview/workshop with the seed-stage investor of Company B. In addition a local VC was interviewed, which are in the network of both companies. Each interview lasted on average 45 minutes and some informants were interviewed more than once. All interviewees were tape recorded and the interviews were conducted in the period April 2013 and June 2013. In addition to interviews, business plans, organizational charts and partnership contracts were collected and analyzed. At the end of the research period two workshops on the same day with the same powerpoint (see Appendix B), each lasting approximately 1.10 hours was carried out. The interviewees and participants of the workshops are summarized and shown in table 2.1 below.

**Table 2.1:** Sources of the interview data

<b>Startup</b>	Interviewee 1	Interviewee 2	Workshop participants
<b>Company A</b>	CEO	CFO	CFO
<b>Company B</b>	CEO	CFO	CEO and CFO
<b>Investor</b>	Pre-seed investor (company B)	Local VC investor	



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## 2.5 Data coding

Data from the first rounds of interview's were first coded into a number of categories suggested by the theoretical model proposed by Yin [1989].

To map the status and plans of the companies in terms of investment readiness, we used the following categories.

1. Financial status
2. Attitude towards equity finance
3. Experience in presenting to investors
4. Attitude towards ownership and control
5. Management readiness - Status and plan
6. Market readiness - Status and plan
7. Technology readiness - Status and plan

In order to do cross case comparisons and analyze the research questions, we used the following categories.

1. Strategy
2. Process: Characteristics
3. Process: Timing
4. Process: interrelatedness
5. Familiarity and uncertainty
6. Information asymmetry

This also gives a basis for comparison between the VC and the Pre-Seed investor findings against the case companies.

## 2.6 Measures to ensure rigor and reliability

In order to ensure rigor and reliability we have used multiple data collection methods, where we we have triangulated the evidence both internally casevice in each interview and across interview and workshop. The use of workshop, interviews, business plans we where able to get a good grounding of the theory. The same

interview guide and workshop presentation where used in both cases, to form a basis of both within-case analysis as well as ability to search for cross-case patterns.

It is apparent that the the method has limitations as both case companies are pre-investment and can only provide data on how they perceive the process all the way to close the deal with an investor. In addition the companies are both early stage, which limits the explanatory power of the research to the early stage of development. However, these cases was consciously chosen as described in section 2.3.

## 3. THEORETICAL DEVELOPMENT

### 3.1 Maximizing the Entrepreneur-Investor Relationship

The advantage of having investors on board for a venture may be a huge benefit for an entrepreneur [De Clercq et al., 2006], both by having access to finance and other value adding resources. However, according to Shepherd and Zacharakis [2001] the potential is contingent upon being able to establish a open and trustful relationship. According to De Clercq et al. [2006] the entrepreneur's first and most difficult task in the pre-investment phase is locating an investor that is willing to invest. However, this might be a challenge as it is difficult for the entrepreneur to assess whether they are *investor ready*, and time the need for funding.

Further it is more than just getting capital, as securing a good relationship implies finding the *right* investor, where a foundation for a good match are contingent on complementary skills, commitment and a potential for a open and trustful relationship [De Clercq et al., 2006]. The entrepreneur need to find an investor prepared for new investments, complementary industry preference, a good track record, and a preferred '*investability*' stage matching the stage of development of the venture [De Clercq et al., 2006]. In addition it is important to secure the right amount of money, ideally just

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enough to get to the next development stage as equity is priced higher the more mature the venture becomes [De Clercq et al., 2006]. Pricing is difficult in the earlier stages of investment, which makes it harder for seed and start-up stage ventures to arrive to a fair and equitable deal structuring.

According to De Clercq et al. [2006] there are three major sources of equity finance available to the entrepreneur, namely *business angels (BAs)*, classic or professional *venture capitalists (VCs)* and *corporate venture capitalists (CVCs)*. These have important typological differences in their assessment of the venture, and would affect the entrepreneur in assessing, developing and time it's *investor readiness* in advance of when the infusion of funding is needed.

### 3.2 Types of equity investors

All investor types are generally motivated by equity growth. However, investors are heterogeneous and part of becoming *investor ready* is learning how to attract the right investor, which starts with learning what different *types of equity investors* look for [Mason and Kwok, 2010]. One major difference between BAs and the other two types, VCs and CVCs, is the fact that BAs are informal, i.e. individuals investing their own money, and the others are institutionalized, i.e. incorporated funds, [Os-nabrugge, 2000]. Hence, using the analogy of B2C and B2B marketing, selling equity to BAs could be compared to a B2C sale, when selling to VC and/or CVC are compared to a B2B sale. In this lies the fact that BAs could invest due to idiosyncratic criteria, whereas VCs and CVCs have to follow strategic firm guidelines [De Clercq et al., 2006]. According to Mason [2005] BAs constitute the largest pool of equity capital available for start-up and emerging companies in advanced economies. However, they might be the hardest investor to find, as the market is often characterized as "*invisible*".

Hence, regardless of BAs being prone to invest earlier than VCs (De Clercq et al. [2006]), *attracting* them might be challenging for the entrepreneur.

Mason [2005] define BAs as "*high net worth individuals who invest their own money, along with their time and expertise, directly in unquoted companies in which they have no family connection, in the hope of financial gain*". Where the majority according to Mason [2005] are successful, cashed out entrepreneurs. Mason and Harrison [2000] argue that BAs play an important role in filling the gap between family, or "proof of concept" money, and VCs that normally don't make as early and small investments. According to De Clercq et al. [2006] BAs often invest in *Seed stage* deals with a strategy of attracting VCs financing of the *Start-up stage*. VCs raise and manage venture capital funds, from limited partners, that they typically have available 10 years in order invest in a portfolio of growth seeking ventures [De Clercq et al., 2006]. A group of VCs constitute what is called a Venture Capital Firm and as an industry they invest in all stages (however most in the start-up and growth stages) and lots of industries, where the goal is to maximize profits by equity growth liquidated in a profitable exit [De Clercq et al., 2006]. CVCs act as a financial intermediary of a non-financial company, e.g. a technology company [De Clercq et al., 2006]. They have both financial and strategical incentives for investing (De Clercq et al. [2006]) and might be a viable RnD partner, customer, market channel or supplier for the venture as a value adding service. Table 3.2 present important characteristics and differences, that is important for the entrepreneur's searching and targeting potential investors.

According to De Clercq et al. [2006] entrepreneurs should be aware that these investors types represent partly complimentary and partly overlapping sources of finance, and are often investing in syndicate deals.

**Table 3.2:** A characterization of the three types of equity finance (Adopted from De Clercq et al. [2006], adjusted with insights from Mason and Stark [2004] and Denis [2004])

	Business Angels (BA)	Professional Venture Capitalist (VC)	Corporate Venture Capitalist (CVC)
<b>Source of funds</b>	Investing their own money	Investing funds of outside limited partners	Investing corporate funds
<b>Legal form</b>	General partnership	Private individual	Subsidiary (or part of) a large firm
<b>Typical size of investment</b>	USD 50k-2M	USD 2-10M	USD 2-20M
<b>Financing stages</b>	Seed and Start-up	All stages, mostly Start-up and later	All stages, later preferred
<b>Geographic proximity preferences</b>	Very close proximity is preferred	Close proximity is preferred	Proximity less important
<b>Motive for investing</b>	Equity growth and personal interest	Equity growth only	Strategic value and Equity growth
<b>Investment criteria</b>	Growth, mentoring prospect and personality fit	Growth prospect and great management	Strategic value and 'fit'
<b>Finding investors</b>	Easy to find, public available information	Hard to find, 'invisible market'	Few, but easy to find
<b>Time to reach agreement</b>	Lengthy and extensive due diligence	Relative quick to reach agreement when 'fit'	Hard to reach 'fit' requirements
<b>Involvement post-investment</b>	Low to extremely high, informal and operational	Moderate, formal and direct or indirect board participation	Low to moderate, informal or board participation

However, despite the typological differences, according to De Clercq et al. [2006] the process an entrepreneur need to carry out prior to investment essentially consists of the same six generic steps; namely:

1. Learning about investors requirements and identify potential investors
2. Checking referrals
3. Contact investor, whereas the investment proposal get screened by the target investor
4. Entrepreneur meet and "pitch" to the in-

vestor

5. Term sheet negotiations and agreement
6. And after the investors due diligence process, the last step is Shareholder agreement negotiations and agreement

The entrepreneur need to time the start and execution of these *pre-investment activities*, parallel to the development of the venture in order to get the infusion of money when needed. The process needs to be coordinated with the investors pre-investment activities, where the three investor types poses different challenges in the different steps of the process as noted

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above. Hence, the entrepreneur needs to assess, plan and coordinate both external and internal processes in timing the infusion of equity funding, effectively coordinating their own *investor readiness*.

### 3.3 Defining Investment readiness

*investor readiness* could according to Douglas and Sheapherd [2002](p. 222) be defined as “*the ability to attract significant external investor funding from business angels and/or venture capital funds*”. Hence, suggesting that investor readiness as a property of a venture could be developed and evaluated in terms of the degree of external investor (however, constrained to BAs and/or VCs) funding that is, or could be, attracted. However, Douglas and Sheapherd [2002](p. 222) further state that a venture will be investor ready “*when at least one investor is willing to invest, and therefore foresees sufficient return on investment, feels that the risk is at tolerably low levels, and does not expect to incur excessive monitoring, due diligence, psychic or opportunity costs in addition to the cost of purchasing equity in the venture*”. Hence, investor readiness is to some degree related to specific individual investors, suggesting that investor readiness contains levels congruent with being investor ready. There will always be some investors that are more willing to invest than others, thus the entrepreneur’s task will be to assess the investor readiness of the venture, and further identify the investors that will be most likely to see the startup as investor ready [Douglas and Sheapherd, 2002].

Another related, and somewhat synonymous, concept is *investment readiness* (e.g. Mason and Harrison [2001]; Mason and Harrison [2004] and Mason and Kwok [2010]), which the authors interpret as similar to investor readiness, however not constrained to attracting *external BA and/or VC funding*. That is, we define investment readiness as “*the ability to attract significant equity funding from internal and/or external investors*. Further we re-define investor ready as “*levels of investment readiness reached when an investor is willing to invest, and therefore*

*foresees sufficient return on investment, feels that the risk is at tolerably low levels, and does not expect to incur excessive monitoring, due diligence, psychic or opportunity costs in addition to the cost of purchasing equity in the venture*”. Starting from scratch the entrepreneur develops investment readiness, where the first level is reached the first time the venture is investor ready.

Mason and Harrison [2001] argues that investment readiness incorporates three distinctive dimensions. The first dimension is the *entrepreneur’s attitude towards equity finance*, which relates to the entrepreneurs willingness to share ownership and control with external investors. The second dimension is *presentation failings*, which relates to shortcomings in the entrepreneur’s ability to sell the business case to the investors they target. The third, and according to Mason and Harrison [2001] the most fundamental, dimension of investment readiness relates to the ‘*investability*’ of the business case. The investability of the business case refers to whether or not the business case meet the requirements of a target investor [Mason and Kwok, 2010]. Hence, developing investment readiness and reaching levels incorporates three barriers that the entrepreneur need to overcome.

The entrepreneur’s first barrier is the willingness to trade equity and control in the venture against the potential contributions of external investors. It is apparent that it would be difficult for entrepreneurs to give up equity if they do not know the value of potential target investors. Essentially this means that entrepreneurs need to inform themselves and understand the role and potential value contribution of different sources of finance (Mason and Harrison [2004]), in order to know if the equity-investor trade might be profitable and contributing to the investment readiness of the venture. Getting the *right* investor could affect the equity aversion, as De Clercq et al. [2006] argues tat the value contribution is contingent upon establishing a successful cooperative relationship. It is apparent that the direction that investment readiness is developed is related to the goals of the venture, and thus the equity

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aversion is connected to goal congruence at each level.

According to Mason and Kwok [2010] because entrepreneur's lack information, or fail to seek out the information that does exist, they essentially approach inappropriate investors. This relates to the second barrier, as learning how to present the business case in a way that attracts the target investor is constrained by any lack of information. According to Mason and Kwok [2010] investors reject investment proposals due to lack of information, and/or poorly made business plans or executed oral presentations. Mason and Kwok [2010] found that the entrepreneur's was perceived as too focused on product/technology, essentially failing to sell the whole 'investability' of the business to investors.

The third barrier is developing the business in such a way that it meets the requirement of the target investor. According to De Clercq et al. [2006] there are four stages in the development of the venture, related to different types of financing needs; Seed Financing, Start-up Financing, Expansion Financing and Buy-out Financing. Each stage relates to different characteristics of the development of the venture, potential investor types and reason for funding as showed in table 3.3 below.

Douglas and Sheapher [2002] argues that the investor readiness, or what Mason and Harrison [2001] label 'investability', of the venture could be broken down in three dimensions; (1) *technology readiness*, (2) *market readiness* and (3) *management team readiness*.

1. The venture's technology readiness develops and increases as technology are developed and the concept are proven, as the know-how and technology get protected, as prototypes have been built and successfully been tested for durability and reliability, and as new products or services can be mass produced at a unit cost that allows for sufficient profit.
2. The venture's market readiness increases as a function of marketing efforts, i.e. as concepts and prototypes are tested and

matched towards the needs and wants of the target customer, as pilots are sold, and as the finished product or service are sold at quantum. Investors look for businesses with growth potential, so an important part of increasing market readiness is verifying that there is a substantial demand in the target market, that are willing and able to pay at a price that could give a good return on the investment.

3. The venture's management team readiness develops and increases, as the venture attain and test a management with the right management acumen, prior related industry and market experience, prior start-up experience, and right commitment to launch and growth of the venture.

According to Douglas and Sheapher [2002] many entrepreneurs has felt that it is indeed 'management ready' but cannot gain funding because investors perceive 'holes' in the experience and qualifications needed for the particular venture. Mason and Kwok [2010] argues that the issues that the entrepreneur have in assessing and developing it's investment readiness essentially relates to information failure, caused by an asymmetrical information distribution between the entrepreneur and investor. *information asymmetry* is thus a source to a failure in the supply of early stage venture capital (e.g. Denis [2004] and Aernoudt [2005]), where venture's require rigorous examination to overcome this asymmetry and become investor ready [Mason and Harrison, 2004].

### **3.4 Investment readiness, information asymmetry and uncertainty**

According to Shane and Cable [2002] information asymmetry stems from the fact that people possess different information and beliefs, and because of this some individuals recognize opportunities that other cannot yet see. In an

article assessing how investors cope with information asymmetry [Shane and Cable, 2002]

argues that the information possessed by the entrepreneur creates two problems while seeking external finance.

**Table 3.3:** Describes investability in terms of financing needs per stage, need for funding and potential types of investors (De Clercq et al. [2006] and Douglas and Sheapherd [2002])

	Seed Financing	Start-up Financing	Expansion Financing	Buy-out Financing
<b>Technology (T) readiness</b>	Proof of concept, but undeveloped technology	Prototype ready to be tested for durability and reliability, ready for initial marketing	Product tested for durability and reliability and ready for mass production and marketing	Product ready for mass production at profitable unit cost
<b>Market (M) readiness</b>	Customer need not verified, business concept undeveloped	Pilot sales have been carried out, other marketing info ready	Several sales, demand verified, ready for growth	Revenues generated with sustainable profits
<b>Management team (MT) readiness</b>	1-2 entrepreneurs	Structure and MT in place	Organizational expansion, and MT tested	Established and proven MT
<b>Main purpose of the funding</b>	Enabling technology and business concept development	Establish marketing and sales activities	Launch of full scale marketing activities	Management BO, Leveraged BO or Delisting
<b>Typical equity investor type</b>	BAAs, sometimes CVCs and VC	VC and CVC, sometimes BA	VC and CVC	VC

First, the entrepreneur might be reluctant to disclose critical information as this might give away the competitive advantage [Shane and Cable, 2002]. Second, the entrepreneurs have incentives, both financial and psychological, and ability to engage in opportunistic behavior as they have information that the investor lack [Shane and Cable, 2002]. It is apparent that information asymmetry is highest in the earlier phases of the Entrepreneur-Investor interaction ([Arthurs and Busenitz, 2003]), effectively contributing to an uncertainty and bounded rationality (Sørheim et al. [2011]) in creating a mutually beneficial relationship (Lahti [2012]; Denis [2004]).

Information asymmetry apparently goes both ways, whereas the entrepreneurs possess

information about themselves and their opportunities that potential investors do not possess (Shane and Cable [2002]), and entrepreneurs lack information about investors requirements and their value adding potential, e.g. their relevant industry/market experience and network [Cable and Shane, 1997]. Mason and Kwok [2010] argues that entrepreneur's lack information and advise on the advantages of raising equity, what it means to be investor ready, and how to become investor ready. Thus, taking an entrepreneur's perspective on information asymmetry it is apparent that they face reciprocally the same two problems as investors do when seeking external finance. Investors might be reluctant to disclose critical information, e.g. on their actual commitment to support the ven-

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ture getting to the next stage, and the investor also have incentives, both financial and psychological, and the ability to engage in opportunistic behavior as they have information that the entrepreneur lack Cable and Shane [1997]. Effectively, information asymmetry causes uncertainty that affects the entrepreneur's ability to develop its investment readiness to a level of investor ready.

The information asymmetry between the entrepreneur and investor also partly generate, or is partly generated by, a knowledge specificity between the two [Cable and Shane, 1997]. Knowledge specificity means that the two parties specialize in the development and contribution of different types of knowledge, allowing each party to exploit its comparative advantage in their respective fields [Cable and Shane, 1997]. Entrepreneurs specialize in recognizing and exploiting opportunities and the day-to-day development of new business activities, whereas the investors specialize in creating networks of individuals and institutions to reduce the cost of acquiring capital, to find customers and suppliers, and establish the venture's credibility [Cable and Shane, 1997]. Cable and Shane [1997] argues that the two parts are complementary to each other, thus making a good foundation for a profitable collaborative relationship. However, the knowledge asymmetry could result in difficulties in understanding each other which might explain some of the difficulties for entrepreneurs to become investor ready. Effectively, underlining the importance of getting the *right* investor fitting the venture's stage in development of its investment readiness.

The challenge of finding a willing and complementary investor is related to the entrepreneur's ability to assess and present the 'investability' of the venture, and hence related to the financing stages. According to Lahti [2012] and Shane and Cable [2002] information asymmetry is highest in the earliest stages of development, where Lahti [2012] argues that it decreases, as evidence on investability becomes more *tangible* when the venture matures. It is apparent that tangible evidence, such as a working prototype of the product,

would increase the entrepreneur's ability to present the business case towards investors. According to Sørheim et al. [2011] investors' lack of familiarity with the venture, and/or the intangible characteristics of the venture's in the earlier phases, leads to uncertainties related to the perceived investability. Hence, one could argue that presentation failings of the entrepreneur is related to the investors perceived uncertainty of the investability of the venture. As investors only deal with levels of risk, i.e. when all possible outcomes are known, (Sørheim et al. [2011]) the lack of investment readiness effectively causes the financing gap in the supply of early stage venture capital (Mason and Kwok [2010]), as shown in table 3.4. Hence, the challenge for the entrepreneurial venture's is to transform the venture, characterized by perceived levels of uncertainty related to market, technology and management team readiness, to the level where investors can evaluate the venture with a rational risk assessment [Sørheim et al., 2011]. Effectively this relates to all three dimensions of investment readiness, as they affect the ability to become investor ready.

As investors look for investment opportunities within industries they have prior knowledge and network (e.g. Mason [2005]) in order to limit this information asymmetry and uncertainty, entrepreneurs should do the same. It is apparent that familiarity, i.e. reduced knowledge asymmetry, and reduced information asymmetry would help the entrepreneur in presenting the case to investors, effectively reducing the perceived uncertainty. Hence, given that the investability is at a seed level, the *right* seed investor could contribute in order to make the venture investment ready for start-up financing ([De Clercq et al., 2006]), effectively increasing the ventures investment readiness. Table 3.4 summarizes the effects of information and knowledge asymmetry in relation to financing stage, together with the investors' possible contribution to investment readiness and their desired return. Hence, relating investability, presentation failing and equity aversion to the financing stages.

**Table 3.4:** Describes information asymmetry and perceived risk in terms of phases, main benefit investor might add and the entrepreneur's main challenge per phase (De Clercq et al. [2006], Sørheim et al. [2011] and Lahti [2012])

	Seed Financing	Start-up Financing	Expansion Financing	Buy-out Financing
<b>Information asymmetry level</b>	Very high	Rather high	Medium	low
<b>Investors perceived risk level</b>	Uncertainty	Rather high	Medium	low
<b>Investors desired return</b>	80-100 per cent	40-70 per cent	25-40 per cent	20 per cent
<b>Main investor expertise and benefit beyond money</b>	Structure, discipline, sounding board, attraction of additional (external) funding and technological insights	Marketing experience, recruiting, contacts, attract follow-on financing, Technology insights, test marketing and piloting. Reputation benefits	Marketing experience, recruiting, contacts, follow-on financing, plan and execute exit. Technology insights, test marketing and piloting. Reputation benefits	Legal and other expertise how to execute a buy-out deal.
<b>Investability contribution potential</b>	TR +++, MTR +++, MR+++	TR++, MTR++, MR++	MTR++, TR+, MTR+, MR+	TR, MTR, MR

As the table shows, investors might increase the investability level of ventures, effectively increasing its investment readiness. However, low investability and information asymmetry also implies that the entrepreneur have to give up more equity [De Clercq et al., 2006]. Hence, entrepreneurs would benefit from improving the investability benchmarked against getting ready for the *right* investor. Mason and Harrison [2001] and Mason and Kwok [2010] argues that professional advisors facilitating investor readiness programmes have the potential of improving the general investment readiness level of early stage venture's, however these are expensive and 'anyways' require that the entrepreneur *know what they do not know* [Mason and Kwok, 2010]. Lahti [2012] found that all types of advisors, e.g. friends, teachers, lawyers, accountants, board members etc. had a positive effect on reducing the information asymmetry and investors perceived un-

certainty, especially in the early stages of development. Hence, a bootstrapping solution for the entrepreneur to cope with information asymmetry in its development of investment readiness could be to use advisors in their social network.

### 3.5 Investment Readiness and Social Ties

According to Uzzi and Gillespie ([1999], p.33, as cited in Shane and Cable [2002]) social ties, *both direct and indirect*, interject expectations of trust and reciprocity into the economic exchange that, in turn, activate a cooperative logic of exchange. This logic promotes the transfer of private information. [Shane and Cable, 2002] define a *direct tie* as "a personal relationship between a decision maker and and the party about whom the decision is being made". Further, an *indirect tie* is defined as "a relationship



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*between two individuals who are not directly connected but through whom a connection can be made through a social network of each party's direct ties"* (Burt, 1987 as cited in Shane and Cable [2002]). According to Shane and Cable [2002] both direct and indirect ties can provide an advantage to people who seek to obtain resources from others, while being under conditions of uncertainty and information asymmetry. Hence, social ties would help entrepreneur's develop its investment readiness achieving *right* investor ready levels along the way.

[Shane and Cable, 2002] supports that the information asymmetry and uncertainty is highest in the seed phase, and argue that investors are unable to make contracts that cope with the risk associated with this phase. However, many entrepreneurs have successfully obtained VC (Shane and Cable [2002]), CVC, and/or BA (De Clercq et al. [2006]) funding in this phase, suggesting that there are ways in coping with the information asymmetry and uncertainty. Osnabrugge [2000] argues that VCs perform an extensive screening to overcome the information asymmetry before setting a perceived secure contract, whereas BAs are more prone to rely on incomplete contracts, and a more active 'hands-on' involvement in the venture. However, both VCs (Shane and Cable [2002]) and BAs Sørheim [2003] use social ties extensively to cope with the information asymmetry affecting their investment decision. It is thus apparent that both economic and social embedded solutions are applied to some degree in the pre-investment process. In order to reach the optimal contract, information asymmetry needs to be limited (Osnabrugge [2000]), where social ties are used as an effective device to overcome uncertainties prior to forming the contract. Hence, the entrepreneur would benefit from actively using the network to get access to private information and reputation about the investor.

De Clercq et al. [2006] stresses the importance of getting the right investor at the right time in order to achieve the full benefits of equity finance and secure continuous growth. Effectively, continuously developing investment

readiness by getting and timing for the right investor ready level along the way. However, there are limits to the amount of investors the entrepreneur are able to meet, and as 'over shopping' might have a negative effect on the funding decision the entrepreneur is constrained in it's ability to find and assess potential investors. According to Lahti [2012] advisors decrease information and knowledge asymmetry, thus increasing investment readiness by educating, aligning expectations and mediating contact to the right investor for the venture [Lahti, 2012]. Effectively advisors, both formal and informal as mentioned above, are able to reduce information asymmetry and uncertainty by helping entrepreneur's to build investment readiness, e.g. polishing business plans and 'pitch' (Lahti [2012]), and may give the entrepreneur an indirect tie mediating contact between the entrepreneur and the investors, e.g. reducing perceived uncertainties in the investability of the project. Effectively, limiting the problems in reaching the right investor ready levels of investment readiness.

The network an important screening device, assisting in processing of information that keeps the entrepreneur up-to-date on developing opportunities (Burt,1992, p. 14 as cited in Shane and Cable [2002]), effectively a tool for the entrepreneur in building investment readiness. It is apparent that advisors might provide some of the investability contributions as mentioned in table 3.4 above, where Lahti [2012] argue that they have largest effect in early stages, effectively increasing the value of the venture ensuring a better potential for an fair an equitable deal. It is apparent that an investor, e.g. at level 1, also might function as an advisor developing the investment readiness towards investor ready level 2. Hence, building network should be viewed as part of developing investment readiness, throughout the stages of development, towards realizing the potential of the venture.

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#### 4. PROPOSED THEORETICAL MODEL FOR INVESTMENT READINESS

In this section we present the theoretical model for investment readiness based on finding from initial mapping interviews and the reviewed literature in section 3. This is used to analyze and discuss the research questions in section 6 in light of the empirical findings that are presented in section 5 below.

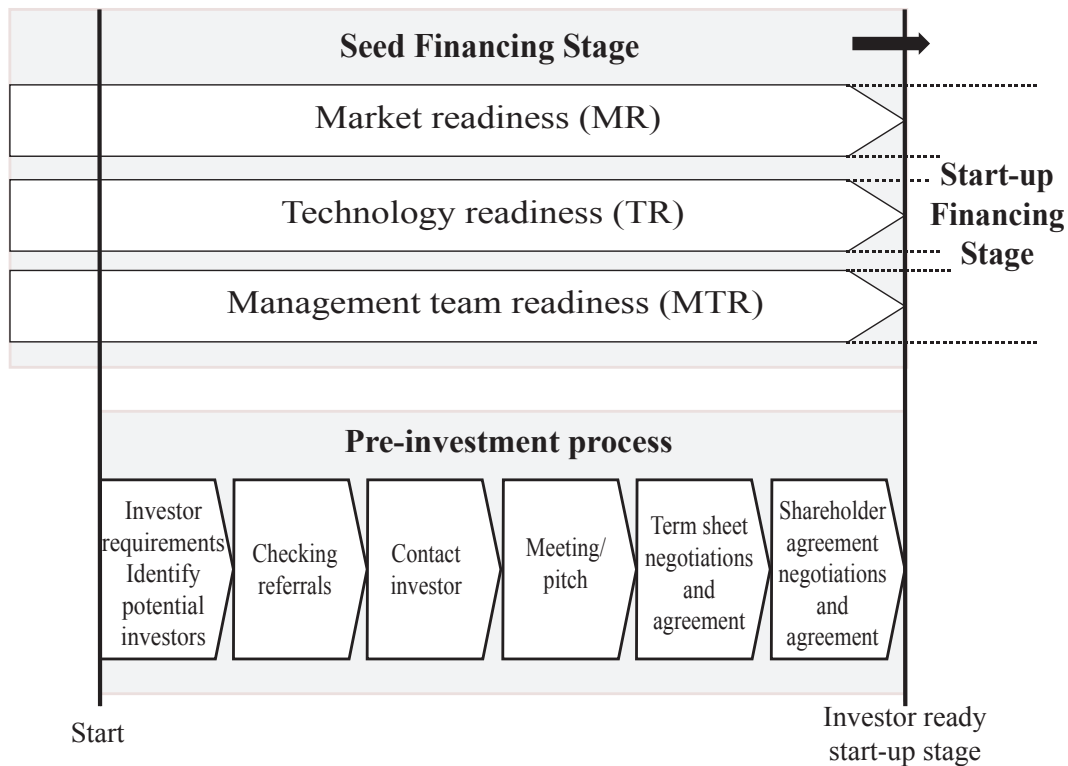
We have defined investment readiness as *"the ability to attract significant equity funding from internal and/or external investors"*. Further we have re-defined investor ready as *"levels of investment readiness reached when an investor is willing to invest, and therefore foresees sufficient return on investment, feels that the risk is at tolerably low levels, and does not expect to incur excessive monitoring, due diligence, psychic or opportunity costs in addition to the cost of purchasing equity in the venture"*. We have discussed the importance of attaining the *right*.

Investment readiness increases as the investability is developed through the development stages of the venture. There are different types of potential investors interested in different stages of investability related to the different levels of investment readiness, e.g. investor ready for seed stage investability. In order to reach a level of investor ready the entrepreneur need to identify, check referrals, contact and pitch for the potential investor, negotiate and reach agreement on term sheets, and lastly get through the due diligence process to the last step of negotiating and reach a shareholder agreement. In section 3 its argued that the venture faces information asymmetry and uncertainty with varying intensity along the stages of development of its investment readiness, that affect equity aversion, presen-

tation failings and levels of risk associated to the investability, in the process of becoming investor ready.

In developing investment readiness throughout the life cycle of the venture it is necessary to reach levels of investor ready along the way in order to exploit the potential of the venture as the venture are unable to fund the growth by internal resources alone. The direction of the investability of the venture is affected by each level of investor ready, thus it is important to screen and be able to get ready for the right investor levels along the way. This affects the valuation of the equity, thus in becoming investor ready it is important to ask for the right amount of money, and get a fair and equitable deal structuring. Ideally the have the right amount of money is the amount that get the venture to the next financing stage, as equity is priced low in the early stages of investment readiness. In getting a fair and equitable deal structuring it is important to reduce any information asymmetry and risk related to the investability of the venture in order for the investor to be able to make a rational and fair assessment of the investment readiness of the venture.

Hence, investment readiness is a continuous process and a property of the venture that have levels of investor ready along the way. It develops through financing stages, which incorporates activities of developing investability and interrelated pre-investment activities that need to be coordinated and timed in order to reach levels of investor ready. Figure 4.1 below is an example snap shot of the demand-side structure of the investment readiness process of becoming investor ready for the Start-up Financing stage, effectively reaching a Start-up Financing level of investor ready.



**Figure 4.1:** Snap shot illustrating the structure of a venture's development of investment readiness towards the level of investor ready for start-up financing stage

According to the theory developed it is apparent that the process of developing investment readiness is not as structured and linear as illustrated in figure 4.1, as both processes are mutually dependent and affected by information-, knowledge asymmetry and uncertainty. The process-model arguably need to incorporate information transfer mechanisms between the entrepreneurs and investors as the demand-side development of investment readiness need incorporates both the timing and execution of both processes, i.e. building inevitability parallel to timing the start of the pre-investment process As there are no contractual relation between potential investors and entrepreneurs in the reinvestment process theory suggest that the entrepreneur's use network ties to assess, time and execute the de-

velopment of investment readiness, reaching the right levels of investor readiness by overcoming equity aversion, presentation failings and ensuring a match between investability and investor criteria. By addressing our research questions we effectively test the proposed model, and investigate how the process is executed.

## 5. PRESENTATION OF CASE STUDY FINDINGS

In this section we present our empirical findings. First we present a VCs and the pre-seed investors view on the best way a venture can become investor ready. Followed by a presentation of the case companies related to the fol-

lowing structure: 1) Financial status, equity aversion and presentation skills, and 2) status and plan for investability.

This will serve as a background for analyzing and discussing how the case companies plan and develop their investment readiness, and cope with potential challenges, in order to become investor ready. It will also provide a basis for analyzing the differences between the companies, and compare their strategy towards the investors' view of the process of becoming investor ready. We will then use this background, combined with discussions from workshops carried out on analyzing the theoretical model together with each case company, to present an emirical model for investment

readiness.

## 5.1 The VCs view on Investor Ready

*"It would be optimal for us to have the chance to follow the venture for about 2-3 years prior to investing, because some teams achieves some of the things they set out to achieve, whereas some don't, and the best way to pick up on this is to follow the team as they develop the venture".* Table 5.5 describes how a new contact is established and assessed in their development of becoming investor ready from the VCs perspective, and how it is related to the VCs perceived risk.

**Table 5.5:** Describes the VCs view on the development of investment readiness of early stage venures, into becoming investor ready

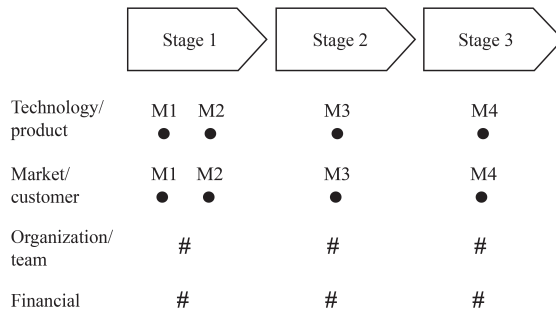
Coding category	Local Venture Capitalist
<b>Familiarity and uncertainty</b>	The risk asociated with the investment is reduced as a function of how long we have known the venture
<b>Strategy</b>	Meet ventures early in their development, even though they are too early in terms of investability criteria. By this the VC get to know the team and their plans, so that they could follow the company until they are mature enough for investment
<b>Typical process:</b> 1) <b>Initial meeting</b>	Either the meeting is initiated by the entrepreneur, or by the VC. Contains a walk through of the industry of the venture, the technology, markets they are working towards and what the plans are in relation to the different needs they face. The VC give advise to the plan. If the venture is interesting, but not yet ready in terms of maturity, the VC ask to be kept informed about the development
<b>Typical process:</b> 2) <b>Pitch meeting</b>	Usually the companies return after 1-2 years, as they assess themselves as matured to the next stage in development, and want to discuss wheter they are ready for investment. In this meeting the VC review the plans they initially proposed in order to assess if the venture have managed to reach the milestones of the plan or not.

## 5.2 The Pre-Seed Investor's Strategy on becoming Investor Ready

*"If you are going to get VC funding for example, then the value of the equity is a decisive factor - and what would bring value for the VC - that you are able to reduce the risk. Reduced technology risk and reduced marked risk. The technology risk is*

*reduced as prototypes are tested, as you are able to show something that works - show something that works and get someone to document that something works. On the market side it's all about pilot customers and get someone that could vouch for that this works - and say something, or show that the customer value is great".* He draws a model on the white board as illustrated in figure 5.2 be-

low and states "This is the story you need to draw when you are approaching an investor".



**Figure 5.2:** Picture that the Pre-Seed investor drew on the white board illustrating the story entrepreneurs need to draw when approaching investors

Figure 5.2 show each stage contains milestones on both technology and market, which could be e.g. prototype ready and paying pilot customer respectively, and within each stage the organization/team need to reflect sufficient capabilities to achieve this. The story need to be trustworthy, i.e. that the team in each stage have the necessary qualities and capabilities to match what need to be done in order to get to the next stage. The story needs to adhere in and over all stages. "Then there is the bottom line -that much cash is needed in each stage in order to achieve this". By doing this the entrepreneur know what the venture need, the bottom line shows what funding is needed. Each stage represent a value adding milestones, which will

### 5.3.2 investability - Status and Plan

Tables 5.8 and 5.9 maps respectively Company A and B, in terms of the status and plan for further development of their investability, i.e. their management team, market and technol-

ogy readiness. Hence, providing a background for analyzing the fundamental part of investment readiness. As the investability is related to potential investors' criteria, it may be viewed as the most fundamental dimension as mentioned in section 3.3.

## 5.3 Mapping of the Case Companies' Investment Readiness

The following subsection provides a mapping of Company A and B in terms of their financial status and the three dimensions of investment readiness. The first part is coded in terms of the two first dimension of investment readiness, namely attitude towards equity and presentation skills. The second part is coded in terms of the third dimension, investability, where status and plan for each company is presented.

### 5.3.1 Attitude towards equity and presentation skills

Tables 5.6 and 5.7 gives the mapping, of respectively Company A and B, in terms of financial status and plan, their attitude towards equity finance and different investor types, their experience in presenting the business to investors, and their attitude towards ownership and control. By this we provide a broad background for analyzing the first two dimensions of investment readiness of the companies.

ogy readiness. Hence, providing a background for analyzing the fundamental part of investment readiness. As the investability is related to potential investors' criteria, it may be viewed as the most fundamental dimension as mentioned in section 3.3.

readiness, overcoming information asymmetries and uncertainties, in order to become investor ready.

Using the theoretical model for as pro-

## 6. ANALYSIS AND DISCUSSION

In this section we analyze and discuss how the entrepreneurs plan and develop investment

**Table 5.6:** Mapping of attitude towards equity finance and presentation experience of Company A

Coding category	Results Company A
<b>Financial status</b>	The company has gained approximately 5 MNOK in soft funding. The financials can keep the business running in 0,5-1 year (dependent on some soft funding they may get), hopefully enough to develop the technology and prove the concept. Plan to approach several investors in order to evaluate different alternatives, as the "worst case" is that they need equity funding within february 2014. They plan to obtain a mix of 45% soft funding and the rest from customer and investor funding. Estimate a need for 15 MNOK for building a demo product
<b>Attitude towards equity finance</b>	The management team (mgt) wish to obtain a VC or industrial investor (CVC or funding from industrial partner) within a year, but they first need to convince the inventing co-founder. While the mgt team rush to develop the technology to reach the window of opportunity before it closes, the inventing co-founder has plenty of time. The mgt do not wish to rush the investment search and take hasty conclusions, but rather evaluate several investors as they go along. However, this is difficult since the company will be running out of cash eventually. " We don't have a choice, we need cash to develop the prototype". Ties have already been established between the team and one VC and two CVCs. The CFO believes it will be easier to obtain funding from a CVC or an industrial partner at an early stage, since these investors are perceived more risk avers. The CFO also prefer CVC or industrial investors as these could add both market and technical value in addition to covering some of the development cost, but the most important investor criteria is that there is goal congruence between the investors and the entrepreneur team.
<b>Attitude towards ownership and control</b>	Company A has until now survived on soft funding and they wish to wait as long as possible before acquiring investors in order to increase the valuation of the company so that the equity will be worth more. However, in order to get a full scale prototype developed and tested they need to acquire equity funding as the development is capital intensive. The attitude towards giving up ownership and control is diversified in the team, where e.g. the inventing founder is reluctant to give away ownership and control in his "baby". The management team have a "pragmatic view" as they perceive investor funding as more of a necessity. Today the the management team has more shares in the company than the board of directors, but the decision control on the board is balanced. If the company acquires an investor, the management team hopes to acquire a new CEO with extensive industry experience. Goal congruence and personal fit is important criteria for the entrepreneurs when assessing investors, where the CFO states "you can say what you want, but are you going to have a person in your board it needs to be a likable person".
<b>Experience from investor presentations</b>	The company have experience in presenting for investors at several business plan competitions, where they was awarded first price in a national competition this year. In addition they have made initial presentations for one VC and two CVCs. During competitions they present the whole business case, but do not wish to disclose any technical details in investor meetings if the investor refuses to sign a non-disclosure agreement (NDA). The initial meetings are mostly used to tell investors about the team, achievements, the customer, market, value proposition, business model and critical milestones to achieve, without mentioning any technical details. However, as VC was part of the jury in a business plan competition he already knew the technical details in their first "introduction meeting". Anyways the focus and feedback from investors is mostly on market and industry, where technology was perceived as "risk free" as the industry professionals from the advisory team vouches for the feasibility of the technology. They perceive special risk in meetings with CVC as they have the capabilities of "steeling the tech", but sometimes it is necessary to disclose some information in order to discuss the technology and potential areas of application with the CVCs. The CFO plan to present to more CVCs than VCs and believes that initial meetings and presentations is a good way of identifying potential investors and a relationship-building activity with the investor.

**Table 5.7:** Mapping of attitude towards equity, finance and presentation experience of Company B

Coding category	Results Company B
<b>Financial status</b>	The company has received 3 million in soft funding. They estimate that they need infusion of funding in February 2013 in order to sustain growth. The CFO estimates that the company need 4-10 MNOK in funding over the next 2 years to reach the current goals. The team is now searching for a industrial customers that is willing to fund the development of the technology. This is a deal partly financed by governmental soft funding, the company and customer funding, where the customer's get exclusive rights to use the technology in applications for increased production qvotas. It will effectively give 1.5 MNOK and is due to be signed in june 2013.
<b>Attitude towards equity finance</b>	The entrepreneurs are open to equity finance and have already assessed some potential investors. They already have a Pre-Seed Investor as a co-founder, which they view as part of the team. As the venture have developed the CFO have experienced that the value adding of the Pre-Seed Investor has increased congruently, as he brings a lot of industry experience and contacts. Through the network of the Pre-Seed investor a bank have approached the company in order to introduce them to a business angel network. However, they believe they can manage a less expensive investment process if the deal with the industrial customer is closed. The entrepreneurs believe that the company will be more fitting with VC criteria if they can create more products, as they believe their market potential of the first product is to small for VCs. They are reluctant to approach investors because they feel this could give away their bargaining position. Instead they will try to get an introduction or wait for the investors to approach them, through word of mount and/or publicity in media. They believe angel investors or smaller VCs would be the best fit, investability vs. criteria vise, at the time being. Still, the management team has ties to several VCs and CVCs in Norway, bot direct and indirect through their Pre-Seed investor. Especially they have good relation to a industrial partner that they are considering as a potential equity investor. The entrepreneurs evaluates a two-step investment model that would give better conditions for the team in round two, but they reflect on that this also induces a higher risk.
<b>Attitude towards ownership and control</b>	The entrepreneurs are willing to give away control if they acquire a VC, but this should imply that it is the right investor with expertise to make the company "fly". The entrepreneurs still do not want to give away too much control and try to be as little dependent of investors as possible. The entrepreneurs state that if they don't feel that the investors understand them in terms of strategy and vision, this may give them cold feet. The entrepreneurs' criterion to equity funding is that they contribute with enough capital in order to accomplish something the entrepreneurs believe is reasonable compared to their loss of control in the company. Personal fit criteria is valued high, and involvement is positive only contingent on whether the investor have complementary skills and ability to add value
<b>Experience from investor presentations</b>	The team have extensive national and international experience from presenting their business case to investors, and have won several business plan competitions that have contributed with around 1MNOK of the soft funding they have received. They have met and presented to several investors at informal networking events, but have not had any "formal" contact with potential investors yet. They believe that the presentation and approach depends on the investor type, as they reflect on BAs as more informal and with a individual interest, than VCs which are more professional. The Pre-Seed Investor takes care of most investor screening through his network, but the entrepreneurs plan to create direct ties this autumn. The entrepreneurs always participate in all meetings with industrial partners (some of which are viewed as potential equity investors). They state that they have learned a lot about communication in these processes that will help them in a potential pre-investment process.

**Table 5.8: Mapping of management team, market and technology readiness company A**

Coding category	Results Company A
<b>Management readiness</b>	<p><b>Status:</b> The daily operations is performed by a team consisting of 6 young entrepreneurs: CEO, CFO, CMO, and CTO plus two technical engineers. The entrepreneurial team has worked approximately 1,5 year on the concept and has already won an eminent business plan competition. The team has no previous business or industry experience, but the whole team have relevant masters degrees in their respective fields. They have gathered experienced members to both the board of directors and advisor board, which provides advise and industry experience, network and expertise. Oh the board of directors they have a member that have 20 years of management and business development experience in the industry. On the advisory board the company has 5 highly regarded advisors from the industry, university and research institutions, with extensive industry and technology experience. They have several industry partners, where one partner states "(...) we believe that the team will manage to create a success of [Company A]."</p> <p><b>Plan:</b> The entrepreneurial team is now searching for an external member as the chief of directors and is looking for someone with extensive experience in business development. Plan to prove and build their mgt capabilities further by reaching milestones on technology and market.</p>
<b>Market readiness</b>	<p><b>Status:</b> Customer feedback and market analysis have indicated that the company is global with an emerging market due to Emission Control Areas (ECA) regulations imposed by government that will take effect in year 2015-2016. There is a broad agreement among authorities and industry actors that the market is emerging rapidly, but right now the entrepreneurs describe it as <i>the calm before the storm</i>. One industry professional state that "(...) have no doubt that there will be considerable customer funding available when the technical development is one step further". Other customers state that the solution is "spot on and the best solution I have seen". It is a vital part of energy supply chain infrastructure, where the value prop of Company A's solution is strong as they solve the problem of existing solutions "expenses are too high, and we are currently out of options". However, the market is conservative and may take 2-5 years before the market is ready for the technology. According to the mgt team the biggest risk the company face is associated with suppliers and customers.</p> <p><b>Plan:</b> Feedback from customers and investors show that the entrepreneurs need to do further cost analysis, value chain analysis, and stronger and quantified value proposition. The team plan to apply for an Industrial research and development Contract (IRD), with a piloting customer within this year. They are currently negotiating with several industrial customers about this deal. The investors also wanted. Currently they have a letter of intent of a customer in piloting the solution full scale.</p>
<b>Technology readiness</b>	<p><b>Status:</b> The company currently has greatest focus on technical development. First miniature prototype has been developed and tested, which has led to some adjustments and the advisory board have verified that the concept works. The venture is now working on concept 2.0 and hope to develop a full scale prototype in about a year, but the development process depends on subcontractors' priorities. The product time and cost intensive to develop and customers require a high degree of accuracy and testing. The company need funding, suppliers, and customers in order to be able to test the product full scale for durability and reliability. The technology in it self is according to the management team "risk free", however it is dependent on suppliers and other industrial in order to be ready for mass production at a profitable unit cost. Investors wanted risk analysis on these costs, and said that the solution needed to be patented in order to be relevant.</p> <p><b>Plan:</b> The company plan to perform risk analysis and concept certifications from a neutral third party before they can start to build the full scale prototype. The company plan to file for patent and are very cautious with trade secrets. Subcontractors need to make calculations and set up a production line. This could in best case scenario take half a year, but the process could be slowed down due to demands from big clients. Since <i>company A</i> is a minor start-up this induces a great risk.</p>



**Table 5.9:** *Mapping of management team, market and technology readiness company A*

Coding category	Results Company B
<b>Management readiness</b>	<p><b>Status:</b> The daily operations is performed by a team consisting of 3 young entrepreneurs: CEO, CFO, CTO and another technical developer. In addition the team receive business development and coaching from two representatives from the Pre-Seed investor. They have outsourced some of the technical development to close partners that is experts in respective fields. Besides the Pre-Seed Investors the team has no previous business or industry experience, but the whole team have relevant masters degrees in their respective fields. The entrepreneurial team has worked approximately 1,5 year on the concept and has already won several eminent business plan competitions. The CEO and CFO work closely together with the Pre-Seed investors who bring relevant industry and business development expertise, and an extensive network of relevant contacts. They have also formed a big network of advisors consisting of research institutions and industry actors. On their advisory board they have according to themselves "the go to guy in the industry".</p> <p><b>Plan:</b> The entrepreneurs plan to acquire a professional chief of directors, preferably a leader in a former industry-relevant company who can bring hands-on experience to the venture. They also plan to acquire an experienced salesperson who can lay down a strategy and boost marketing. The management team plan to take care of all project management and through that prove and build their mgt capabilities further by reaching milestones on technology and market.</p>
<b>Market readiness</b>	<p><b>Status:</b> feedback from customers show that the product is needed because it is a solution to a severe problem in the industry. Customers have shown interest since day 1, where the company have developed strong customer and distribution partner relationships during development. The product will solve a problem of industry growth, as it solves a problem causing the government to limit the production quotas of Company Bs customers. With the technology the government may grant additional production quotas that enables customers to profitably scale it's production. Company B is in the last rounds of negotiation with industry partners and customers for an Governmentally supported Industrial research and development Contract (IRD) which will provide 1,5 MNOK in customer funding from pilot customers. Market potential is estimated to 250-300MNOK a year. The team assess that they will not be market ready for VC funding before they have a portfolio of product. They expect to be ready for small VCs, relevant CVCs and BAs in february</p> <p><b>Plan:</b> The team is planning to confirm market readiness to the next stage by obtaining the IRD (set to close in June 2013), where the potential partners will be given exclusivity to the use of the technology in their production quotas applications. In addition they plan to hire a third party research institute to document and test the effect of using the product - effectively a report stating "this is what you would get by buying our product". The company aim to be ready for marketing of the first product in Q1 2014.</p>
<b>Technology readiness</b>	<p><b>Status:</b> The team has focused on technology development for 1.5 years and has now developed the first working "part-product-prototype" and tested in in use at customer location. They have patented the central pars of the concept. Since the production line for the prototype is the same as for the full scale product they have effectively tested the production process with industrial partners and verified that the product may be produced without extensive investment or alterations to the existing production process. One of the largest independent research organizations in Scandinavia has produced a report based on analysis of the materials used in the product and has thus given a third party evaluation of the technology. They have also successfully tested the</p> <p><b>Plan:</b> The plan is to iterate on this prototype in order to develop a full scale pilot together with their partners ready for launch in customers production at scale in Q2 2014. The entrepreneurs aim to develop a support infrastructure and test the electronics needed with the prototype in order to reduce the time until testing. They plan to patent other parts of the solution, that will lead to interesting opportunities.</p>

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posed in section 4 we first investigate how entrepreneurs plan and develop "their ability to attract significant equity funding from internal and/or external investors". Focusing on external investors as both case companies are developing their investment readiness, in order to reach levels where an external investor is willing to invest, effectively becoming investor ready. Thus, we seek to understand how the entrepreneurs plan and develop their investment readiness so that the target investor "foresees sufficient return on investment, feels that the risk is at tolerably low levels, and does not expect to incur excessive monitoring, due diligence, psychic or opportunity costs in addition to the cost of purchasing equity in the venture". Second we investigate how entrepreneurs cope with information asymmetry and uncertainty in the process, as these factors affect the ability to become investor ready. Lastly, we review the model presented in 4 and propose a model of how the process of developing investment readiness, and its challenges.

## **6.1 How entrepreneurs plan and develop investment readiness to become investor ready**

In this section we will seek to test the theoretical model in analyzing and discussing how entrepreneurs plan and develop investment readiness to become investor ready. We start by analyzing the case companies' status and plan for investment readiness by adopting an 'demand-side' view using the theoretical model proposed in section 4. Effectively, using the model to capture a snapshot of the entrepreneurs' perception of the current development of investment readiness in respectively Company A and B. Further, we will do a comparative analysis and discussion of Company A and Bs' strategy for developing investment readiness and the perceived characteristics, timing, and interrelatedness of the process of developing investment readiness towards becoming investor ready. By doing this we investigate how entrepreneurs plan and develop investment readiness to become investor ready.

### **6.1.1 Analysis of status and plan for Investment Readiness**

By interpreting the findings presented in section 5.3 against the theory underlying the structure of the model we effectively perform an analysis of the status on investment readiness for the cases. As we set out taking the demand side view on investment readiness, and base our analysis on data from the entrepreneurs perspective of their own status of investment readiness. This could mainly be viewed as an 'inside-out' analysis as we focus first on the internal need and not the external possibilities of becoming investor ready. We start by analyzing company a, presented in figure 6.3, and follow on with an analysis of company B, presented in figure 6.4. In using the same model theoretical model the companies are compared, where we discuss the similarities and differences of status and plan for investment readiness between the two.

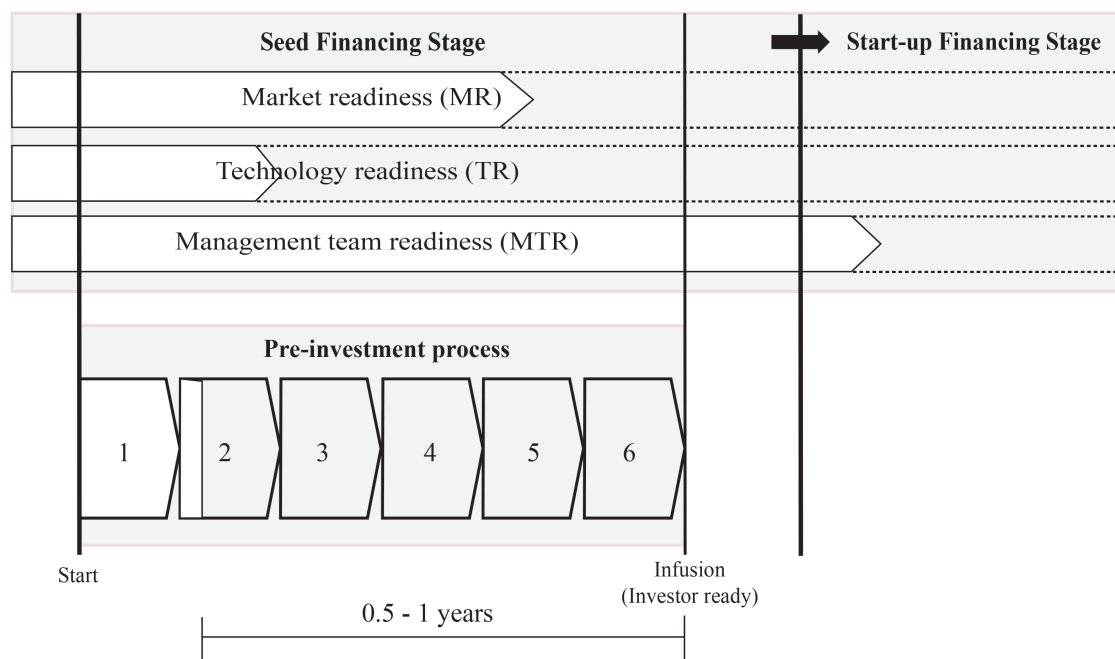
The financial status of Company A, as presented in table 5.6, suggest that they need to be investor ready in approximately half a year to a years time. They have already identified and started to evaluate several investors where they currently both prefer and find it most probable to become investor ready for CVCs in the stage of investment readiness they are in. They want to develop their investability as long as possible in order to increase the valuation of their company. However, they are not particularly equity averse, as development is capital intensive and infusion of equity capital is viewed as a necessity in order to finance further development.

Reviewing table 3.3 in section 3.3 we analyze the investability in terms of the financing stage. According to Company A they need infusion of equity in order to finance their contribution in the IRD deal with the government and industrial partners, in building and piloting a prototype. Hence, the first investor ready level need to finance the company in getting ready for start-up financing. The company have a management team in place, i.e. more than just 1-2 entrepreneurs, but they are young

and inexperienced. However, the extensive network of experienced advisors, industrial partners, and a competent board suggests an management team readiness that exceeds the seed stage into the start-up financing stage. The business concept is developed and tested in several competitions, and strong environmental factors suggest that it is an huge emerging market. The value for target customers have been verified to the degree that a customer have signed a letter of intent to pilot the solution in an IRD. However, IRD need to be granted and equity is needed to cover Company As' part and the company plan to have close a deal with an industrial customer by the end of the year. The technology is undeveloped, but the concept is verified as feasible by industry pro-

fessionals in the advisory board so in that way it is perceived as "risk free". However, the concept need to be certified and patented before a prototype could be built. Hence, we argue that the technology readiness is still early into the seed stage. The technology is planed to be ready for development in a year, corresponding with the target investor ready level.

Figure 6.3 provides the snapshot of the investment readiness process, where the status on investability and pre-investment activities towards becoming investor ready for funding further development into becoming ready for start-up financing. The white areas illustrate the current status in the process in relation to the financing stages.



**Figure 6.3:** Inside-out analysis providing a snapshot of status and plan for investment readiness for Company A, where the steps in pre-investment process refers to; 1) Investors requirements and identify potential investors, 2) Checking referals 3) Contact 4) Meet and "pitch", 5) Term sheet negotiations and agreement and 6) Shareholder agreement negotiations and agreement

As the figure show management team is theoretically ready for a start-up financing round, however technology and market readiness have some development left before they theoreti-

cally are investor ready. Company As financing need corresponds, according to table 3.3, with the main purpose of seed financing stage as they need funding to get to the next stage.

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Hence, in terms of development stage Company A could theoretically get ready for BAs, CVCs and some VCs. However, as they need about 15 MNOK BAs would, according to table 3.2, not be able to fund the entire infusion alone.

The financial status of Company B, as presented in table 5.7, suggest that they plan to be investor ready in half a year to one year's time. They have reached the level of "pre-seed stage investor ready" as they have an external pre-seed investor as owner and part of the management team. Now they have started to identify some investors, especially been contacted by a network of BAs that are interested. However, the contact is made through the network of the pre-seed investor congruent with the theoretical role of a seed stage investor, as described in table 3.4, in its contribution to investment readiness beyond money. In the first round the company think they are more likely to reach a BA level of investor ready, however they want to wait until they have reached a deal with a customer to get a less expensive investment process. They are not particular averse towards equity finance, as they view investor funding as a viable option to sustain the speed of invisibility growth.

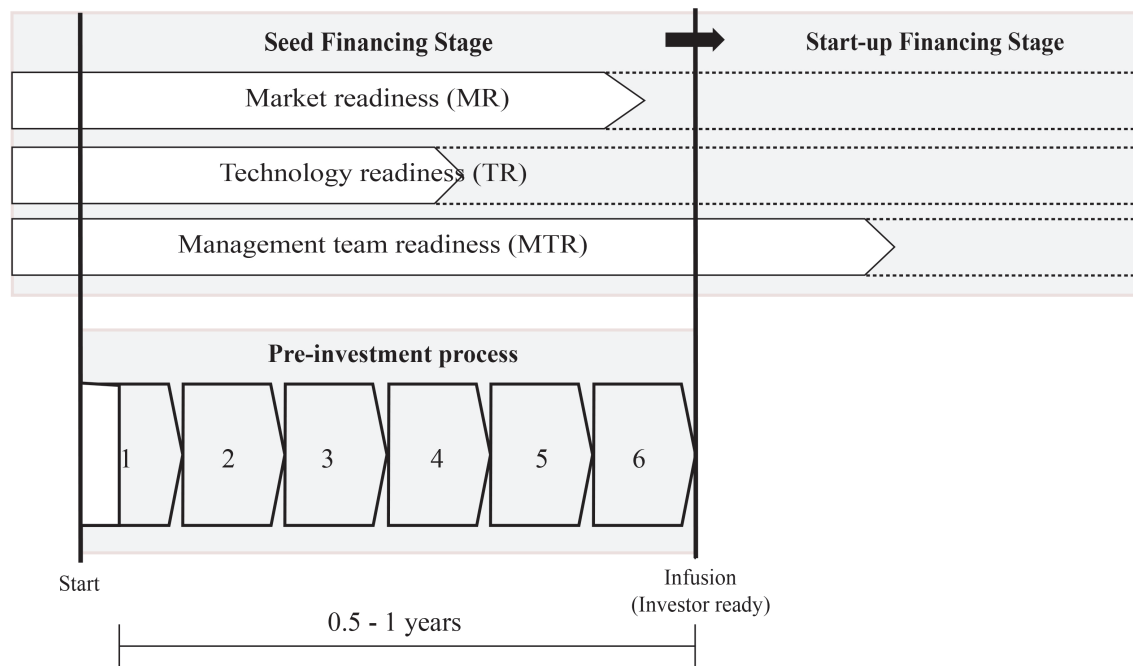
According to table 3.3 we interpret Company B to be looking towards becoming investor ready for start-up financing stage. In terms of invisibility they have reached a bit further into the seed financing stage than Company A in terms of market readiness, as they are in the finishing stages of negotiation with customers and plan to close the IRD deal June 2013. They have also developed their technology readiness further, as the concept are patented and a part-prototype are tested. The production has also been tested, and the a full scale prototype is planned to be ready for piloting in February 2014. Similar to Company A, Company B also have structure and manage-

ment team in place which suggest a Start-up Financing Stage readiness level. However, the team is also inexperienced even though they also have won several business plan competitions. We evaluate them as being more management team ready than Company A though, as they have an operative Pre-Seed Investor with extensive experience from business development in the industry in their team.

Figure 6.4 provides the snapshot of the investment readiness process, where the status on invisibility and pre-investment activities is illustrated. The white areas illustrate the current status in the process in relation to the financing stages, where the plan is to develop investment readiness into becoming investor ready for start-up financing stage.

The figure shows that also the management team readiness of Company B is theoretically ready for the start-up financing stage, however there are some development left before a full scale prototype have been tested and the pilot sale have been carried out. Hence, reviewing table 5.9, the plan is to develop investment readiness into being ready to establish marketing activities, which according to table 3.3 is defined as the main purpose of start-up financing. Effectively, plan to reduce the perceived uncertainty, which described in table 3.4 will give a better price on equity (70-40 per cent desired return). Because of the market potential they find themselves as being more of a BA case than VC, however also CVCs or other industrial investors have been considered.

It is apparent that evaluating the status and plan for investment readiness is relies on information, where potential investors perception of the investment readiness of a venture is affected by information asymmetry and any unfamiliarity with the company. Company A is looking to develop investment readiness to acquire seed financing to fund the development of the first prototype.



**Figure 6.4:** Inside-out analysis providing a snapshot of status and plan for investment readiness for Company B, where the steps in pre-investment process refers to; 1) Investors requirements and identify potential investors, 2) Checking referrals 3) Contact 4) Meet and "pitch", 5) Term sheet negotiations and agreement and 6) Shareholder agreement negotiations and agreement

Effectively they need to overcome the 'very high' information asymmetry and perceived uncertainty in seed stage, in order to become investor ready. Company B has in theory got a better chance of becoming investor ready, as they seek to finance the company in a later stage of development. However, accruing to our analysis both companies plan to develop investment readiness further in order to become investor ready. The investors view would depend on the entrepreneurs ability to communicate the business case to potential investors, i.e. the second dimension of investment readiness as presented in section 3.3. It is apparent that information exchange is part of the process of developing investment readiness. This will be discussed and analyzed in the following section. Hence, part of developing investment readiness is overcoming information asymmetry, as this relates to the perceived risk from both sides in the tie between the venture and investor. The information asymmetry is related

to the development stages, as it is perceived higher the earlier stages of development. This should in theory affect the companies different, as they seek to become investor ready in different stages of development. An analysis of how the companies are affected by risk and uncertainty is provided in section 6.1.3, where we discuss how entrepreneurs overcome information asymmetry in becoming investor ready.

Company A have presented to several investors already one might argue that they have come to step 5 in the pre-investment phase. However, they call it introduction meetings, which correspond to terminology used by the local VC as presented in section 5.1. According to the Local VC, the typical process is that the companies get feedback and come back 1-2 years later when they have developed their investment readiness into being investment ready. The risk associated with the investment is reduced as a function of how long they have known the venture. Management team readi-

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ness is important and interrelated with the relation between the entrepreneur and investor, as it is assessed through following the team in achieving milestones towards becoming investor ready. The strategy and process of becoming investor ready is discussed in more detail in section 6.1.2 below.

### **6.1.2 Strategy and Process of developing Investment Readiness towards Investor Ready**

In this section we will analyze and discuss the strategy and process that the companies adopt in developing investment readiness seeking to achieve the planned investor ready level. The discussion is structured around comparative analysis of the strategy, and the characteristics, timing, and interrelatedness of the process of becoming investor ready. In each analysis the information provided stems from workshops with each company discussing the theoretical model of investment readiness as proposed in

As the table shows both Company A and B are consciously using network ties as a strategy of developing their investment readiness in becoming investor ready. Building a trustful relationship, through interaction in direct and indirect social ties, is perceived as essential to reduce the investors perceived risk in the investability of the venture. Social ties are also used to learn about different investors and select the appropriate investor and the optimal timing for investor ready of the venture. Both companies argue that building a trustful relationship essentially implies proving management team readiness towards the investor, and that it is interrelated with developing market and technology readiness. However, Company A seem to have employed a slightly different strategy than Company B in that they have already established direct contact. Whereas both value an early meeting with the potential investors, Company B start by using indirect ties seeking to obtain a referral, and/or work to be contacted by the investor.

section 4.

Reviewing the proposed strategy of the Pre-Seed Investor in section 5.2 the "story" that is presented to investors need to be trustworthy, i.e. the management team need to be able to convince the target investor about the technology and market readiness. In this he emphasizes that the team have to show that they are able to achieve what is planned. The investor need to trust in that the management team will be able to develop the company toward realizing the potential. It is apparent that even though the management team readiness is in theory ready for start-up stage financing from an inside-out perspective, there is an information asymmetry that need to be reduced in order to become investor ready. As presented in section 3.5 both direct and indirect social ties may be able to transfer this information. As table 6.10 shows this is incorporated in both of the company's strategy for becoming investor ready.

It is worth noting that establishing an early direct tie, that enables the investor to follow the company in its development of investment readiness, is compatible with what we found to be preferable to the local VC. Investors need to know the plan in order to be able to assess the extent of the management team's ability to achieve what they set out to. Effectively, this strategy gives the investor an informal 'governing' role towards the company as they are presented with the outcomes that is planned to be achieved. This information could to an extent be transferred through indirect ties, i.e. indirect monitoring, however that would be less effective as the transaction relies on a mediating link. By having both the quality of information transfer should increased.

As theory suggest, investors may contribute by increasing the investment readiness of the company by advising the company in the process. Company B have the pre-seed investor on board effectively contributing to the investment readiness of the company, both by contributing to the investability and screen for investors

**Table 6.10:** Description and comparison of the companies strategy for building investment readiness into becoming investor ready

Coding category	Company A	Company B
<b>Network strategy</b>	Building relationship by starting with a direct approach, and screening through indirect ties. "I meet [VC 1] an [VC 2] at an networking event, that was sort of casual, but we agreed on an introductory meeting". Meeting the investor early and establish contact and start building the relationship in order to have alternatives when you need funding down the line. "I feel there is two things you need to do: You have to go to the investor and talk about yourself, and get them interested. Then you need to ask them a lot of questions. Kind of an investor due diligence. In addition you need to talk to others that have had this investor. Was there any conflicts, was there any problems and that sort of things. Then you have to evaluate- okey, are we aligned with this investor? Then you have to look into how you could get this investor to invest in you". Becoming investor ready is about building a trustful relationship, "the more time you spend building the relationship initially, the less time you spend in negotiations"	Building the relationship by starting with an indirect approach building reputation and screen, then seek to get referrals into a direct tie. "[CFO:] you try to screen for who's good, that you do subconsciously all the time -it's basically word of moth". The CEO states: "We have always talked about getting an investor at one point or another, and in that way [Pre-Seed Investor rep], talked about our case to people he knows - placing 'seeds' here and there all the way." They find it important to meet potential investors early to start and build a trustful relationship. However, as the CFO states: "it may be naive, but you do need to talk to them. Get and introduction -preferably trough someone else. It is a power game, you want them to contact you". Becoming investor ready is about building a trustful relationship, as the CEO states: "Yes, [to the former] that's my claim -you have to show that you have something, that you are actually capable of achieve the things you set out to do" That you actually have something to show for".

using his network. However, Company A strategy effectively enables the management team to access the value adding advises of the investors pre-investment and provides a direct tie for investors to reduce the perceived risk associated with assessing the management team readiness.

In order to assess these strategies further we need to analyzing how the companies per-

Apparently both companies perceive the model as not being able to show the iterative nature of the process. Taking a outside-in perspective it could be interpreted as being an iterative learning process where the interactions with investors gives feedback that alter the plan and focus in the development of investment readiness towards becoming investor

ceive the characteristics of the process of developing investment readiness. This is done by discussing how the process perceived by each company is related to the theoretical model as presented in section 4. Table 6.11 compares the perceived process of developing investment readiness towards becoming investor ready.

ready. From an inside-out perspective it could be viewed as a selection process, where both feedback from investors (direct tie) and referrals (indirect tie) help the companies in focusing in on the right investor ready level to target fitting their criteria. It is apparent that both companies need to balance between the inside-out and the outside-in view, as the process has

**Table 6.11:** *Description and comparison of the companies view on the characteristics of the process of developing investment readiness into becoming investor ready*

Coding category	Company A	Company B
<b>Process: characteristics</b>	<p>Company A views itself as being in stage 2 in the theoretical model, or having iterated once on the first steps, where the pitch meeting was an introduction meeting. "I think you need a back-loop in the process, as there are no general requirements of investors (...) it is an iterative process. It is like plan an approach, then iterate as you get feedback. Feedback from [individual] investors and different types [of investors] ". In terms of the proposed model the CFO views it as faulty as it does not model the relationship building and selection process good enough. "Your model is sort of like, okay we assess what we have, then we develop it to the point that we are investor ready. However, you need to look at it from the other side as well, what does this investor require, if this is the investor you want. Then you need to plan your approach. Because investors are different and we are not only assessing VCs. Views the process as iterative, not sequential, between the first 4 steps "when you have checked referrals, you need to bring something back to the investor, or you need to bring something back into you plan. All the information you get would in a way alter how you perceive the process. (...) When you have sat down with the term sheet, then you have sort of made up your mind in a way -you can't simply say "just kidding" in that stage.</p>	<p>Company B views itself as being partly into step 2 in the theoretical model, however haven't made any direct contact with any investors other than what they call "part of the informal relationship building activity" at network events. They compare the process as similar to a industrial sale of an undeveloped product/technology, which they have experience with. However, the CFO also argue that the process would be slightly different in becoming VC ready, as they are professional investors. In reviewing the model the CEO argues: "I contend that step 4 [meeting/pitch] and 5 [term sheet negotiations and agreement] is an iterative process that may go on for a while - because it is not one meeting, there are several meetings and several pitches (...) you have many meetings to build a trustful relationship before you agree on the terms, i.e step 5. (...) some of the meetings we present our milestones and thoughts about them. Then they have feedback and thoughts about them which we might need to consider -they have lots of experience and good feedback on how to do things. Then we need to bring back updated plans along the way -show that things are happening -building trust.". The CEO gives critique to the proposed model; "[IRD partners] could become investors and it is all about building the relation all the way. That may not be part - where is that in your model, i.e building the relation?"</p>

both internal and external dependencies.

Further, both investors and entrepreneurs experience learning and selection aspects of the interaction, depending on whether one takes a demand-side or supply side perspective to the process. Investors may select based on their criteria as they learn more about the invisibility of the company, and entrepreneurs learn from the feedback in the process of selecting the right investor. The interaction process thus contain learning and selection, which both affect the process of developing investment readiness to-

wards becoming investor ready.

The table also illustrate how the different strategies affect the perception of how the process. Both describes several interactions consisting of several meetings, but with somewhat different timing. Company A argues that these interactions is carried out in the early stages as part of identifying potential investors and gathering referrals, whereas Company B argues that they expect to iterate later in the process after the potential investors have been identified and screened. However, this could



be caused by a different balance in perspectives where Company A's strategy seem more outside-in oriented than Company B.

Another aspect that may affect this is the the perceived timing of the process, in terms of

how much time each step is expected to take. Table 6.12 summarizes and compares how the two companies perceive the timing of the process of developing investment readiness into becoming investor ready.

**Table 6.12:** *Description and comparison of how the companies perceive the timing of the process of developing investment readiness into becoming investor ready*

Coding category	Company A	Company B
<b>Process: Timing</b>	Started in June 2013 with "introduction meetings", which the CFO assert "is not a pitch. (...) [it is more like]: We just want to talk with you, introduce ourself". They have networked with potential investors for a while. The foreign CVC contacted them, effectively starting the process. Difficult to know the length of the process, from network ties they have heard that the process takes from 4 months (getting 200M) to a year. May be able to postpone the infusion half a year depending on some soft funding, but they anyways need cash to fund the prototype and keep growth. They perceive that the two CVCs are within reach by February, but the VC is more unlikely and state. Time which The CFO argue that the "(...) the more time you spend on the first steps, i.e. developing the relationship, the less time the negotiations will take". Expect to get a staged deal offering, as they can't build the prototype before they have certified the concept"	Have had informal contacts with VCs, but as the CFO states: "we need to start for real in August in order to time the process in order to get the infusion in February -if you start to seek funding in January you don't have any bargaining power". They perceive the negotiations after the pitch meeting to take several months. By now they have relied on the Pre-Seed Investor, as they state "we have let [Pre-Seed Investor] take care of that bit till now, or we count on him having some thoughts on the matter to put it like that. I guess if we didn't have him on board, we would have tried a bit harder". However, the CEO argue that "we only need the money in February in order to keep up the speed of growth, [looks towards the CFO] we don't really need the money right? [Respond:] we could bootstrap for a while, but in order to keep up the speed we need it." Considers two staged model, but find it risky.

This shows that Company B have relied on the Pre-Seed Investor up until now in timing the process, whereas Company A has started the process as they are unsure about how much time it will take to become investor ready. Even though the two companies have a different timing of when, in the pre-investment process, the interactions will happen, both argues that this building trust activity is time consuming. However, the chosen strategies and timing might also be affected by how dependent they are on external funding. Company B have financed the seed stage and argues that they only need funding to keep up a high

growth rate, whereas Company A is dependent on external funding in order to be able to develop the investment readiness into the start-up stage. Essentially, the strategies' balance between inside-out and outside-in perspective would depend on internal and external dependencies. Thus, essentially affected by the perceived bargaining power in the relationship between entrepreneurs and investors.

In it is apparent that the development of investment readiness is affected by several inter-related aspects. We have already discussed the interrelated nature of management team readiness in relation to the way potential investors

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perceive the teams ability to develop market and technology readiness. In addition we it is apparent that market readiness is dependent on technology readiness, as the ability of sell-

As the analysis show, both companies want to develop the investability of the company as long as possible to increase the value of the company, however Company A is more dependent on external funding than Company B to sustain development. Effectively, Company A are unable to fund the seed financing stage of developing investment readiness without becoming investor ready for a seed stage investor. This gives Company B a better chance of getting a good value on the equity, as they are able to reduce the investors perceived risk. This might give reason to the different strategies chosen, where Company A have to spend more time building trust in the relation to investors in order to reduce the uncertainties associated with the seed stage characteristics of development investment readiness.

Company B assess their market readiness to be unattractive for VC funding and 4-10 MNOK might make it hard to find potential BA investors capable of covering the whole amount, whereas Company A have a larger market potential making them more ready for VC funding. However, according to the characteristics of the investor types presented in section 3.2 few VCs are willing to invest in seed stage deals. This is also supported by the findings from the local VC as they typically want to have known the company for 2-3 years before they perceive them as investor ready. Thus Company A might be right in that CVCs are the most probable investor ready level to reach, as they argue that the technology could have a strategic value by strengthening their competitive advantage.

The difference in the strategies chosen, and how it affect the perceived characteristic and timing of the process could be explained by the dependencies related to the above mentioned interrelationships. Being in a seed stage, theory suggest that information asymmetry is

ing a pilot would depend on having developed the technology to a point where customers are willing to test it. Table 6.13 present important interrelated aspects of the process.

very high, which combined with the a intangible nature of the technology makes it more challenging for Company A to transfer the information to investors. Effectively being in an early stage is lowering the ability to build a trustful relationship, and investment readiness due to investors perceived uncertainty in assessing the investability of the venture. However, as we have seen Company A have established an earlier direct tie to potential investors than Company B, which enable them to become seed stage investor ready. It is apparent that developing investment readiness is closely related to reducing the information asymmetry as it affects both learning and selection in the process of becoming investor ready.

### **6.1.3 How entrepreneurs cope with information asymmetry and uncertainty in the process of becoming investor ready**

In this section we analyze and discuss how entrepreneurs cope with information asymmetry and uncertainties in the process of becoming investor ready. During the analysis and discussion of how entrepreneurs plan and develop investment readiness we have found that there is an interaction based on mutual learning and selection between the entrepreneurs and investors where building strong social ties are important in order to become investor ready.

In the inside-out analysis of the status and plan we found that Company A and B both have Start-up stage readiness of their management team, but that part of developing the investment readiness is building a trustful relationship to ensure effective information transfer. Building the relationship essentially affects the quality of information transfer between the entrepreneur and investor, and relates indirectly to market and technology readiness through the perception of the capabilities

**Table 6.13:** Description and comparison of how the interrelations affecting the process of developing investment readiness into becoming investor ready

Coding category	Company A	Company B
<b>Process: Interrelatedness</b>	<p><b>[investability vs. IR]</b> The CFO states that "We want to wait as long as possible with the equity investment in order to build value as much as possible so that we get the best possible price on the equity, but we need infusion so I don't feel we have any choice"</p> <p><b>[MR vs. IR]</b> The company uses governmental soft funding (IRD) to get customer funding, as a strategy to increase investability. In order to get this deal the Company A need to increase their equity capital. Have a huge multinational market potential and need about 15 MNOK to fund. Need VC or CVC to continue growth and get to Start-up Financing Stage.</p> <p><b>[TR vs. IR]</b> Not able to build a prototype and test it without equity funding and need patent: "they [investors] have said that it [patent] need to be granted". Dependent on Industrial partners for becoming TR. TR bottleneck for MR and reaching Start-up stage</p> <p><b>[MTR vs MR and TR vs IR]</b>"(...) if you return without having done anything about their advise, they won't be that willing to invest in you. (...) You need to show them your abilities to execute, before you can talk about any deal. Need to reach milestones on MR and TR in order to build MTR and become IR. Have experienced foreign VC on board</p> <p><b>[Investor type vs IR]</b> "[CFO] think it's more probable in the early stage [of development] we are in to get a CVC, or an Industrial partner to help with costs. "I think in a way that it has been easy to have meetings with them [VCs], since we are in a early stage [of development]." in addition the CVC reflect on that CVCs have additional value as the product could increase their profits through improving their value chain.</p>	<p><b>[investability vs. IR]</b> "The plan is related to major milestones, i.e. prototype ready and ready for marketing, and that will affect the terms and value you get from an investor, so if we delay infusion it would be because our milestones got postponed".</p> <p><b>[MR vs. IR]</b> The company uses governmental soft funding (IRD) to get customer funding, as a strategy to increase investability. Do not need external equity funding to close the deal. Small national [relative] market potential and need about 4-10 MNOK to fund growth. Market potential perceived as too small for VC. Need BAs or CVC to continue growth and get to Expansion Financing stage.</p> <p><b>[TR vs. IR]</b> Need industrial partner (IP) to scale production and distribute market after IRD. "[IP] want to talk with customers to check MR." MR contingent on TR as the technology need to work in order for Industrial Customer in IRD to get production quotas.</p> <p><b>[MTR vs MR and TR vs IR]</b> "(...) you have to show [investors] that you have something, that you are actually capable of achieving the things you set out to do" That you actually have something to show for". Need to reach milestones on MR and TR in order to build MTR and become IR. Have Pre-Seed Investor in team.</p> <p><b>[investability vs IR Type]</b> "[CEO] think that IP funding is one of the best sources to funding together with soft funding [for the company], they may not require equity stake, but they get exclusivity to [produce and distribute] the [future] product, so they are in a way investing and taking risk". "Our current milestones are important in assessing the right match, (...) [BA] needs to be patient so that we have time to get where we are going [before ROI]"</p>

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and trustworthiness of the management team. Essentially, information asymmetry needs to be reduced in order to convince potential investors of the value of the investability. Thus, while analyzing and discussing the first research question we also addressed the second. This corresponds with the second dimension of investment readiness, in that we have found that reducing information asymmetry is an integral part of developing the investment readiness. However, we did not go into depth in answering how the companies cope with this information asymmetry other than using a network strategy to develop investment readiness.

By analyzing the table it is apparent that Company A prefer geographical close investors, as it affects their perceived familiarity and uncertainty in both learning from, and selecting the appropriate investor. This is congruent with the theory of how investors screen for opportunities, which should provide for a good outset. The effect of reputation and the mediating function of indirect ties is likely to increase as a function of geographical closeness as it makes it more probable to find shared connections. Company B have patented the concept

As the table show both companies have difficulties identifying potential BAs. Currently non of the companies know any potential BAs, which is not suppressing as BAs are said to be an invisible market. However, Company B have been approached by a bank that could mediate contact. This comes as a consequence of the Pre-Seed investors network which they use actively to identify and reduce information asymmetry. This again exemplifies a dimension on investors' value adding potential in becoming investor ready.

Presenting the business case is the second barrier to investment readiness in becoming investor ready. In theory it is harder to present the business case the earlier the stage of development. The analysis above support this, as it seems that the maturity of the investa-

In the pre-investment process the companies uses both direct and indirect ties to present and screen for potential investors, but they experience different challenges. Both Companies seek to become ready for the right investor while seeking to maximizing the value of the equity, where the criteria for a good match is goal congruence and personal fit. In this mutual familiarity need to be developed and uncertainties need to be reduced. Table 6.14 Describes and compare the aspects affecting familiarity and uncertainty in becoming investor ready.

and are able to show a tangible part-prototype which would decrease the investors perceived uncertainty. Both use a strategy of indirect ties to reduce uncertainties, where Company A uses advisory board members and Company B uses Pre-Seed Investors network. However, Company A has a larger barrier to cross than Company B as they are in an earlier stage of development. Table 6.15 describes and compare the effects of information asymmetry on the companies ability to become investor ready.

ability of Company A do cause friction in the information transfer in the relation to investors. Company A have difficulties presenting, i.e. it affects learning and rational selection, both for the entrepreneurs and the investor. They cope with this by using indirect ties to vouch for the feasibility of the technology, that enables them to focus their communication around other areas of development. Even though they are not able to go into detail of the technology do present what they plan to achieve in terms of technology and market readiness, effectively giving the potential investor an informal 'governance role' in the relationship. As they are presented with the status and plans, they could essentially evaluate the invisibility by assessing outcomes. Essentially, increasing the investors ability to learn about the quality of the

**Table 6.14:** Describes and compares the aspects affecting the companies perceived familiarity and uncertainty in becoming investor ready

Coding category	Company A	Company B
<b>Familiarity and uncertainty</b>	Establishing a trustful relationship is very important for Company A for reducing risk and uncertainty, where they have established direct ties early to several VCs and CVCs to build trust. Uses indirect ties to cope with uncertainties regarding fit. The national CVC is preferred over the foreign CVC, because the former has a reputation of being "kind" and is "local" in terms of distance. Unable to go into details of product, but uses expert advisors [indirect tie] in vouching for technology. They have showed a local VC with confidential information in a business plan competition, but state that they need to trust the investor in order to disclose any technical details. Plan to use independent institution to prove concept. Still in seed stage, unable to show miniature prototype or concept.	Establishing a trustful relationship is very important for Company B for reducing risk and uncertainty. Uses business plan competitions as a strategy to build credibility and familiarity: "We point to that other similar persons - 'like you' have verified that we are good in what we do". CEO and CFO currently rely on Pre-Seed Investor network in "familiarizing" the company and to cope with uncertainties. Have direct ties to VCs, but feel they have not formally been introduced. Are becoming Start-up stage ready, with a patented concept and "part-prototype" which they use in pitches. They state: "We are close to get the industrial partners with us, relationships built over a year, so maybe that could ease the process with the investor -the trust in that relation"

investability of the company, and improve their capability to do a rational selection. Thus, the adopted strategy of meeting the investor early and build social direct tie effectively reduces the information asymmetry. It may reduce the perceived uncertainty characterized in a seed stage to a level of risk as the investor familiarizes themselves with the possible outcomes of the investment decision.

Both companies find it difficult to evaluate investors, affecting both learning and rational selection, as information from indirect ties is hard to assess. This implies that the companies have to use several indirect ties in the selection process in addition to establishing a direct tie to the potential investors. Hence, the process of building a trustful and reciprocal relationship between entrepreneurs and investors is both an integral part of developing investment readiness, and a way of overcoming problems related to information transfer related to the early stages of growth. Thus, the applied network strategy would increase the entrepreneurs chances of finding an investor

willing to invest, screening for the right investor, and ensuring an equitable deal structuring as it reduces perceived risk.

#### 6.1.4 Proposed empirical model for developing invest investment readiness

Through our analysis and discussion in section 6.1 we found differences in the status and plan for becoming investor ready but that both companies uses a network strategic approach, where both indirect and direct ties is used to transfer information between themselves and the potential investors in the process of developing investment readiness towards becoming investor ready.

The demand-side analysis in section 6.1.1 provided a snapshot of the process, but throughout analyzing the strategy and process of developing investment readiness we found that it is an iterative process, consisting of both aspects of learning and selecting. It is apparent that both entrepreneurs and investors need to learn and select in the process, where. Investors learn about the investability of the

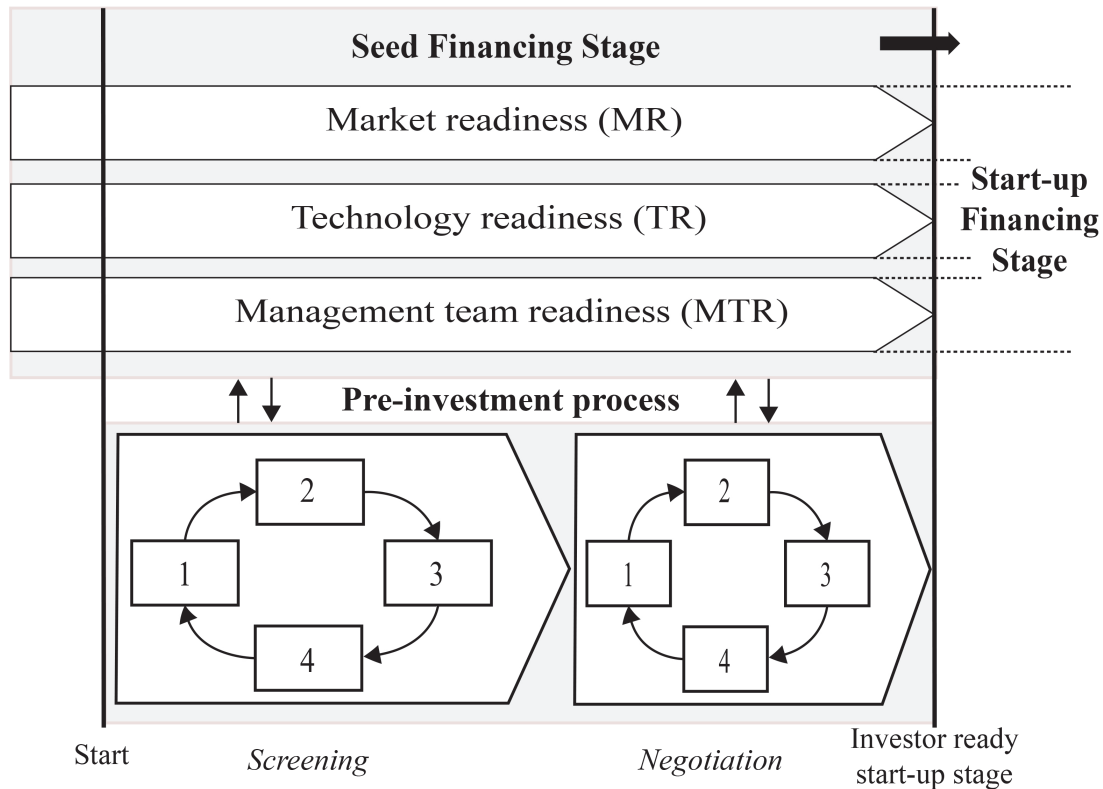
**Table 6.15:** Describes the VCs view on the development of investment readiness of early stage ventures, into becoming investor ready

Coding category	Company A	Company B
<b>Information asymmetry</b>	<p><b>[Identifying]</b> "Have considered BAs, but it was more about the availability -we don't know anyone". Got in contact with VCs during events, got approached by the Foreign CVC after a presentation on industry seminar and having won a business plan competition. Find it easy to identify VCs and CVCs, as they attend networking events and information are publicly available etc. VCs also describe their profile online, i.e. what they look for in terms of investability and stage, but the CFO perceive a slight mismatch between stated criteria and current portfolio.</p> <p><b>[Presenting]</b> Need for NDA prevents a good and open dialog in meetings. "This is difficult, especially with CVCs, in one way you don't get the chance to discuss applications of the tech in detail, but on the other hand there is a risk that they may steal the tech, (...) the VC in the competition signed the NDA, so he got all information. (...) [the others] wouldn't have signed an NDA. (...) while with the CVCs it would take some more time [than towards VCs] to build the trust that enable us to disclose all technical details." However, both the VCs and CVCs focused on value prop, business model and value chain.</p> <p><b>[Evaluate]</b> Difficulties to obtain information regarding fit, but goals and criteria they will state in meetings. "The information you need from them I think will be difficult to get from them". The CFO suggest to ask the investors "who have you invested in and who should I talk to? Then you talk to them and a few they didn't suggest". "we asked a guy on a network event form [Company X in same industry] and he said they had been in contact with [Foreign CVC] as a customer and it was horrible." CFO: "So this is something I will check into - if this is a one-off thing or if it is the norm with [FCVC]"</p>	<p><b>[Identifying]</b> "Finding VCs -well you only have the usual 3 [in Norway], but do they have money?". Have relied on Pre-Seed Investor to find and build relation to potential investors. CFO: "Up until now we have tough -as we don't need BAs now, we haven't search for any, but we will use our network to find potential BAs when we need them". CEO: "I think it would be a good idea to screen for investors using our industry network ties, i got a tip the other day of a guy that co-founded [industrial customer X] that live in [local town] and have cash."</p> <p><b>[Presenting]</b> Have patented the solution, and uses physical "part-prototype" in presentations. Have pitched to several investors during competitions, but argue [CFO:] "that is more part of the informal relationship building activity". CFO argues "(...) whether you are able to communicate market and technology, will indirectly determine whether you [investor/people] perceive that the management team are reasonable". "In presentations to [industrial] customers we have used it [won competitions etc.], i.e. that we are a team that are able to achieve something"</p> <p><b>[Evaluate]</b> Difficult to assess investors' fit, and criteria of VCs and CVCs are easy to find, but hard in the case of BAs, as the CFO argue "you know BAs are such a different [heterogeneous] breed". "Evaluating is difficult, because you get so much different information [word of mouth]. Have experienced that "(...) what others may find negative, we might view as positive, so its very difficult to know if you're making a good decision". They have relied on the Pre-Seed Investors ties in evaluating industrial partners and have done the same in terms of potential equity investors; CEO: "you know he has previous experience there -thats really important."</p>

company, and select according to their investment criteria. The entrepreneur need to learn about the criteria and value adding potential of the investors, and select in relation to how it fits with their criteria. Effectively, learning happens for the entrepreneur in the pre-investment activities, which gives a foundation for targeting the development of investment readiness towards a particular investor. Hence, there need to be an information transfer between the pre-investment process and the process of developing investability to match the criteria of the target investor.

While the theoretical model proposed in section 4 provide some value in analyzing the status and plan of investment readiness, the

entrepreneurs argue that it fails to model the iterative nature of the interaction with the investor in the pre-investment phase. In addition the model failed to incorporate the social embedded information transferring mechanisms that where found to be an integral part of developing investor readiness. In relation to the iterative nature of the pre-investment activities, both find that the process consists of several meetings with different content. However, both indicate that there is a distinction between the screening and the negotiating activities. Based on this we propose a new theoretical model for investment readiness, which is illustrated in figure 6.5



**Figure 6.5:** *New theoretical model for investment readiness*

The model could be applicable for both Company A and B, as it does not give direction on which strategy to chose in performing the screening and negotiation activities. However,

in both cases the negotiation starts when the entrepreneur contacts the investor with the purpose of proposing an investment deal. It is apparent that both indirect and direct ties could

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be applied to implement a chosen strategy, but during the screening phase the entrepreneur should have learned enough to be able to select the right investors that is presented with the investment proposal. In Company As case they have iterated once on the screening activities with three investors, respectively identifying, initial check of referrals, made contact, and had an introduction meeting. In these meetings they have ensured information transfer both ways, by presenting their status and plan for investment readiness and getting feedback to the plan. After developed the invisibility and checking referrals further they plan to have another meeting. This information transfer between the two main processes illustrate the learning of alternatives and getting feedback, and selecting how to precede. The chasing of the two processes, respectively named Seed Financing stage and Pre-Investment process, illustrates interrelatedness between the embedded processes. This way the model is able to incorporate that information learned in the process would alter the entrepreneurs perspective of the whole process, as Company A feels lacking in the first model.

The negotiations is the same learning loop with identifying, checking, contacting and negotiating. First it concerns the terms and second it concerns the shareholder agreement. Here again the information transfer between the negotiation rounds and the stage of development provides a learning-selecting loop. As theory suggest one should not 'over shop' in the pre-investment process, however according to Company A this is most important when proposing a deal. The venture is investor ready, for Start-up Financing stage in this model, when entrepreneur has managed to develop the investment readiness to a level where an investor "foresees sufficient return on investment, feels that the risk is at tolerably low levels, and does not expect to incur excessive monitoring, due diligence, psychic or opportunity costs in addition to the cost of purchasing equity in the venture. Hence, reduced the information asymmetry and uncertainty by building a trustful relationship and convincing the investor of

the readiness of the management team, market and technology.

## 7. CONCLUSION AND IMPLICATIONS

### 7.0.5 Conclusion

The purpose of this paper was to explore the demand-side of the market for early stage equity with the aim of providing a more holistic and comprehensive model for investment readiness. As the definition of investment readiness needed to be understood defined in more detail we started with an inductive approach to building the first theoretical model. This was then used to explore and analyze the process of developing investment readiness in order to become investor ready. The first model served a good purpose in analyzing the status and plan for investment readiness in both companies. However, it was criticized for not being able to capture the iterative nature of the process and how information transfer alter the entrepreneurs perspective on the process.

During the analysis and discussion we found that both companies empaled a network strategic to developing investment readiness, where both companies used direct and indirect ties to transfer information. We found that information transfer mechanisms was an essential part of developing investment readiness as it provides learning and the ability to do a rational selection in the process of becoming investor ready. In addition these information transfer mechanisms where also used to overcome information asymmetry and limit the investors perceived uncertainty, where we saw evidence from using both indirect and direct ties to reduce the perceived risk associated with the invisibility.

At the end we feel we where able to reach our goal in proposing a new theoretical model for investment readiness, which incorporates the social embedded information transferring mechanisms that where found to be an essential integral part of developing investment readiness, overcoming information asymmetry and uncertainty, to become investor ready.



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## 7.1 Implications

### 7.1.1 Implications for further research

We hope the implications of this research provides a foundation to understand how a successful relationship between entrepreneurs and investors could be initiated and developed from an early stage of development. The model opens up for many ways an entrepreneur could become ready for VC funding, as several combinations of investor ready levels could lead to an optimal investment readiness for VCs.

The model is however premature and only tested on entrepreneurial firms before they have acquired seed, and/or start-up stage equity funding. There are many interrelated aspects that needs to be explored in further detail, such as how it relates to the development stages to the company and different levels of investor ready. The model should therefore be explored in several stages, and maybe taking a longitudinal approach in order to capture the process before and after a level has been reached.

The link between the stages and investment readiness also provides an "objective" benchmark for developing the model into capturing both sides of the supply of venture stage equity capital. Hence, it could be used to gain further insight into the market failure as it may be able to relate investment readiness better to the challenges related to information asymmetry and uncertainty in the seed stage of development.

### 7.1.2 Implications for entrepreneurs

Hopefully the this article could assist entrepreneurs in developing their own investment readiness and make strategies that maximizes their chances of getting the right investor at the right time, at the best possible pricing of the equity. As the paper suggest networking is an essential part of becoming investment ready, and the sooner you start building the information transferring mechanisms the more you will be able to reduce the investors perceived risk.

### 7.1.3 Implications for investors

Hopefully this would give you some insights into the challenges the entrepreneur face when seeking equity finance, and provide you with a better understanding of how to initiate and build a cooperative relation to entrepreneurs from the introduction, in order to be able to liquidate the investment in a huge exit. In addition investors should notice the entrepreneurs difficulties in finding potential BAs and seek to establish more publicly available information to mediate contact.

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## A. APPENDIX A: INTERVIEW GUIDE PAPER 2

### A.1 Interview guide for the CEO

1. Relationship context factors:
  - Could you tell us about the status of the company and your role in the company?
  - How did you search for an outside director?
  - How did you meet the outside director?
2. Strategy behind obtaining an outside director:
  - What was the strategy behind appointing an outside director?
  - What was your expectations to the outside director?
  - Have your expectations been met?
  - What do you think the outside director expect to contribute with?
3. Initial contribution of outside directors to the venture.
  - What value has the outside director contributed with to the venture?
  - Which of his/her contributions do you value the most?
  - Why are these contributions valued the most?
4. The venture's management structure.
  - Can you describe the composition of the management team in your company?
  - What are the biggest challenges within the management team?
  - Do you lack any resources on your management team?
  - If so, how do you plan to obtain these resources?
5. The main task of the board
  - What do you think of when you look for a professional board of directors?
  - How does the board operate in your company?
  - What is the main task of the board?
  - How often do you meet with the board of directors?
  - How often do you and the outside director communicate?
  - Do you perceive the outside director as having a controlling function, if so - how?
6. The extent to which each venture achieved a good initial relationship to investor
  - Have you approached, or been approached, by any investors?
  - If so, who's decision was it to approach the investor?
  - How did the outside director contribute in this process?
  - What do you think the investors valued when you were in meetings?
  - What role did the outside director play in these meetings?
7. What changes have occurred in each of the above areas?

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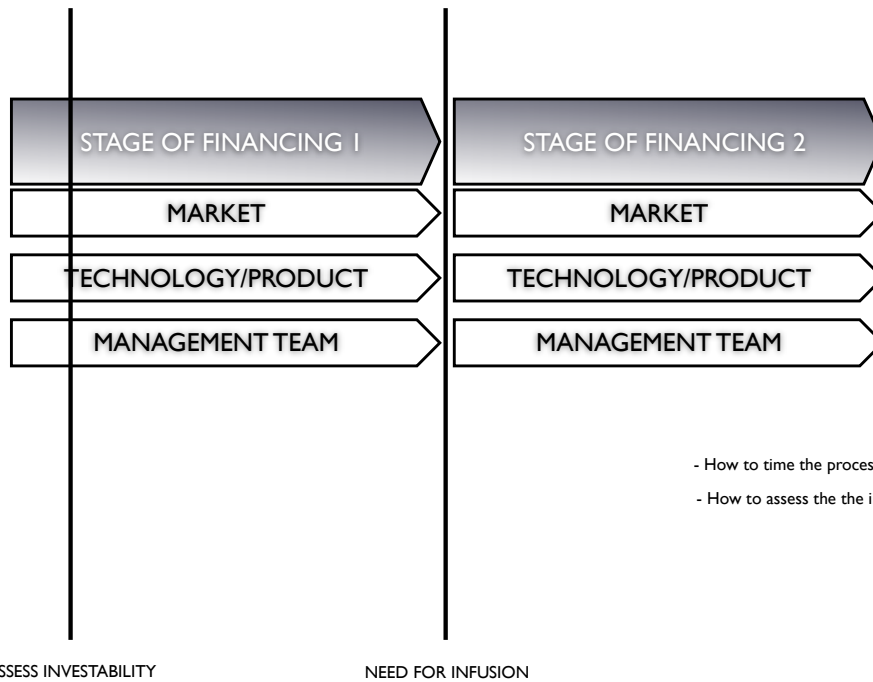
## A.2 Interview guide for the outside director

1. Relationship context factors:
  - Could you tell us about the status of the company and your role in the company?
  - How were you approached by the CEO?
  - How did you first meet the CEO?
2. Strategy behind obtaining an outside director:
  - What was the strategy behind appointing an outside director?
  - What was your expectations to the outside director?
  - Have your expectations been met?
  - What do you think the outside director expect to contribute with?
3. Initial contribution of outside directors to the venture.
  - What value have you contributed with to the venture?
  - Which of your contributions do you value the most?
  - Why do you value these contributions the most?
4. The venture's management structure.
  - Can you describe the composition of the management team in the company?
  - What do you perceive as the biggest challenges within the management team?
  - Do you experience a lack of resources in the management team?
  - If so, how do you help the entrepreneur obtain these resources?
5. The main task of the board
  - What do you think of when you look for a professional board of directors?
  - How does your board operate this company?
  - What is the main task of the board?
  - How often do you meet with the board of directors?
  - How often do you and the CEO communicate?
  - Do you perceive the CEO as having control of the business, if so - how?
6. The extent to which each venture achieved a good initial relationship to investor
  - Have the company approached, or been approached, by any investors?
  - If so, who's decision was it to approach the investor?
  - How did the you contribute in this process?
  - What do you think the investors valued when you were in meetings?
  - What role did you play in these meetings?
7. What changes have occurred in each of the above areas?

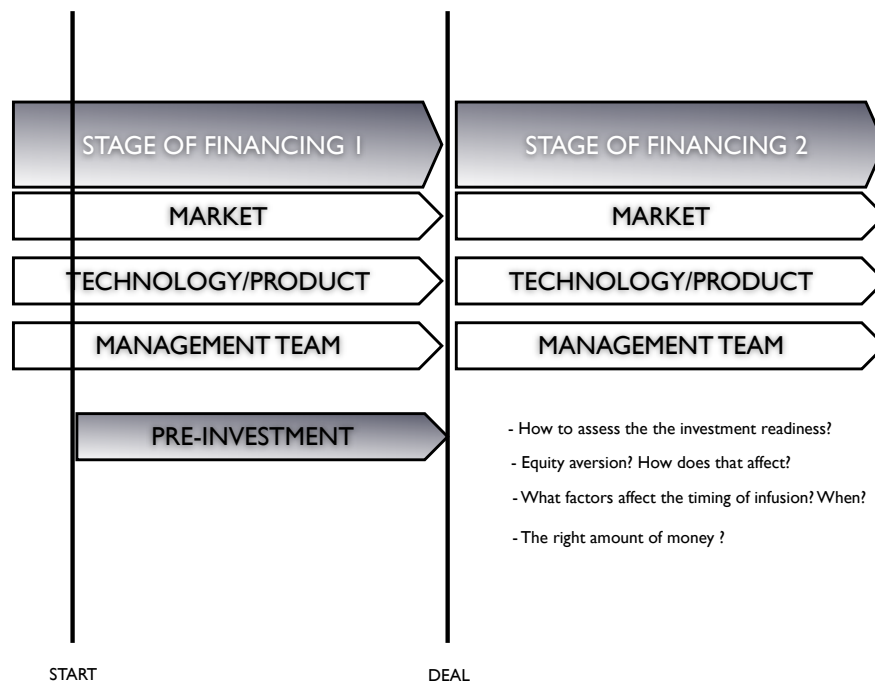


# **How do entrepreneurs plan and assess investment readiness in order to anticipate the timing in advance of when the infusion of capital is needed?**

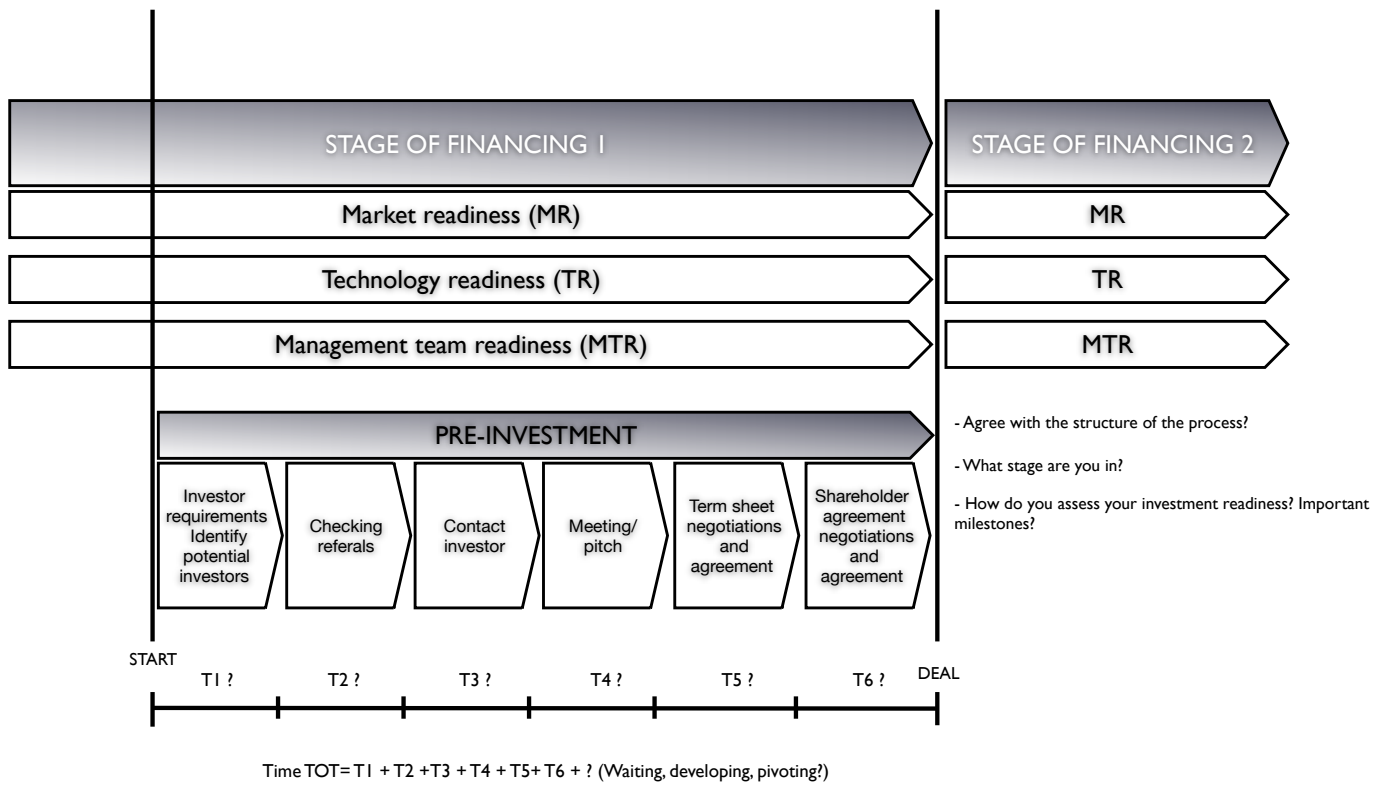
## **B.1 Workshop models**



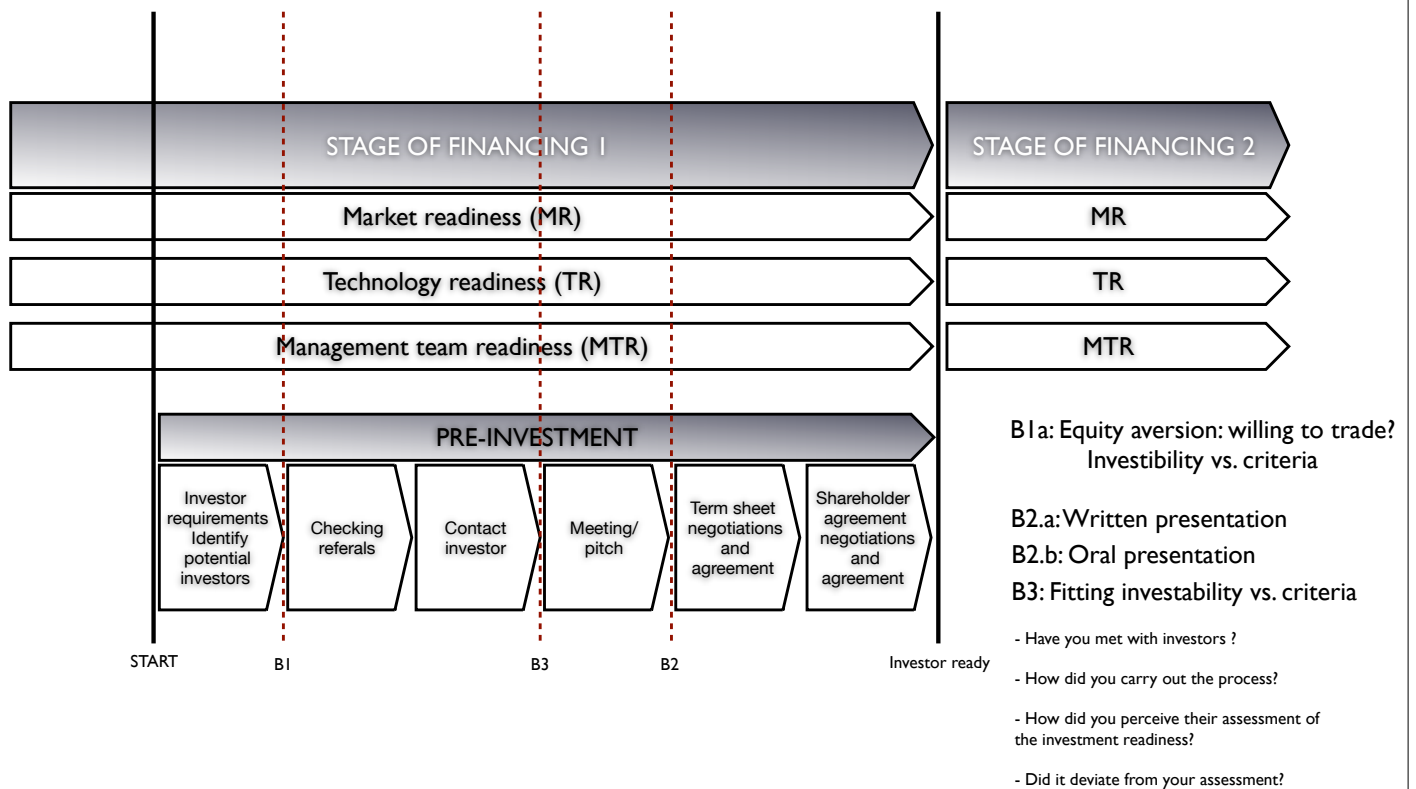
# STRUCTURE



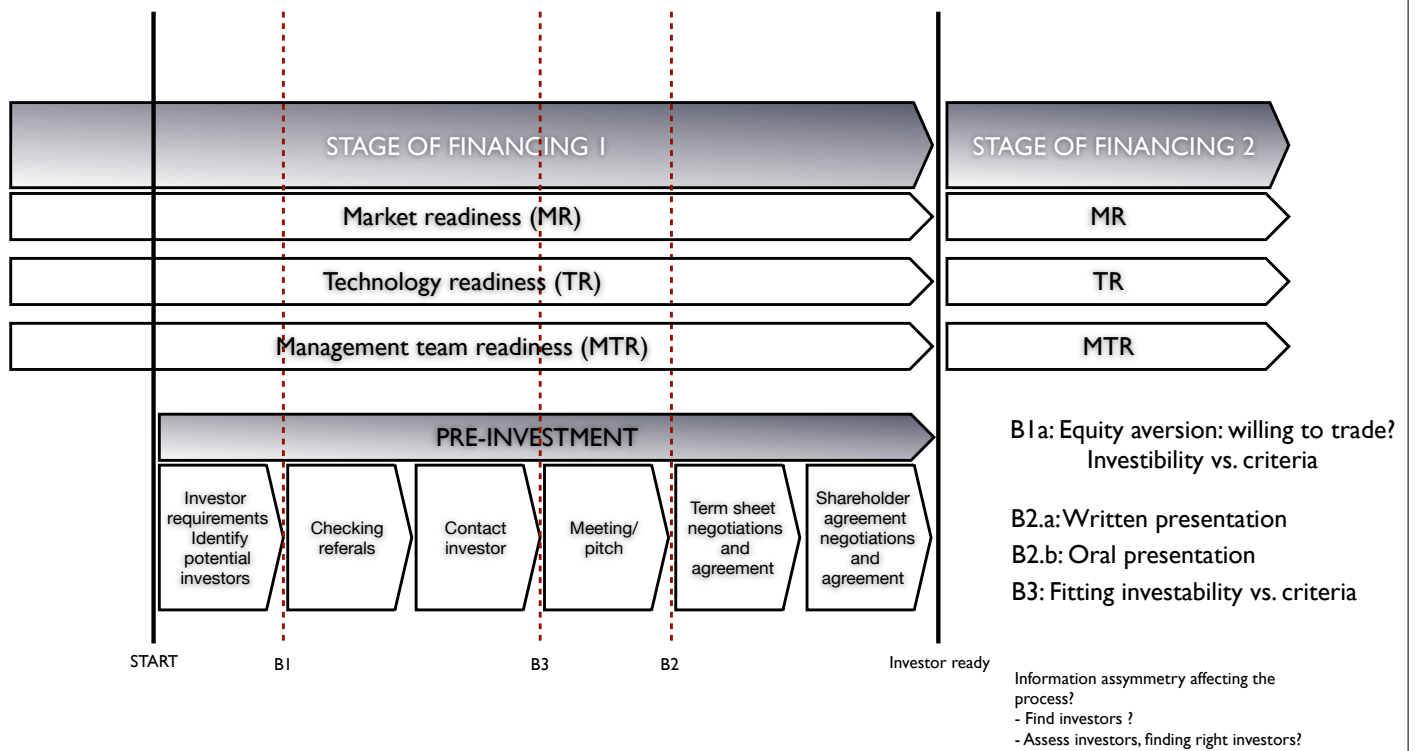
# STRUCTURE



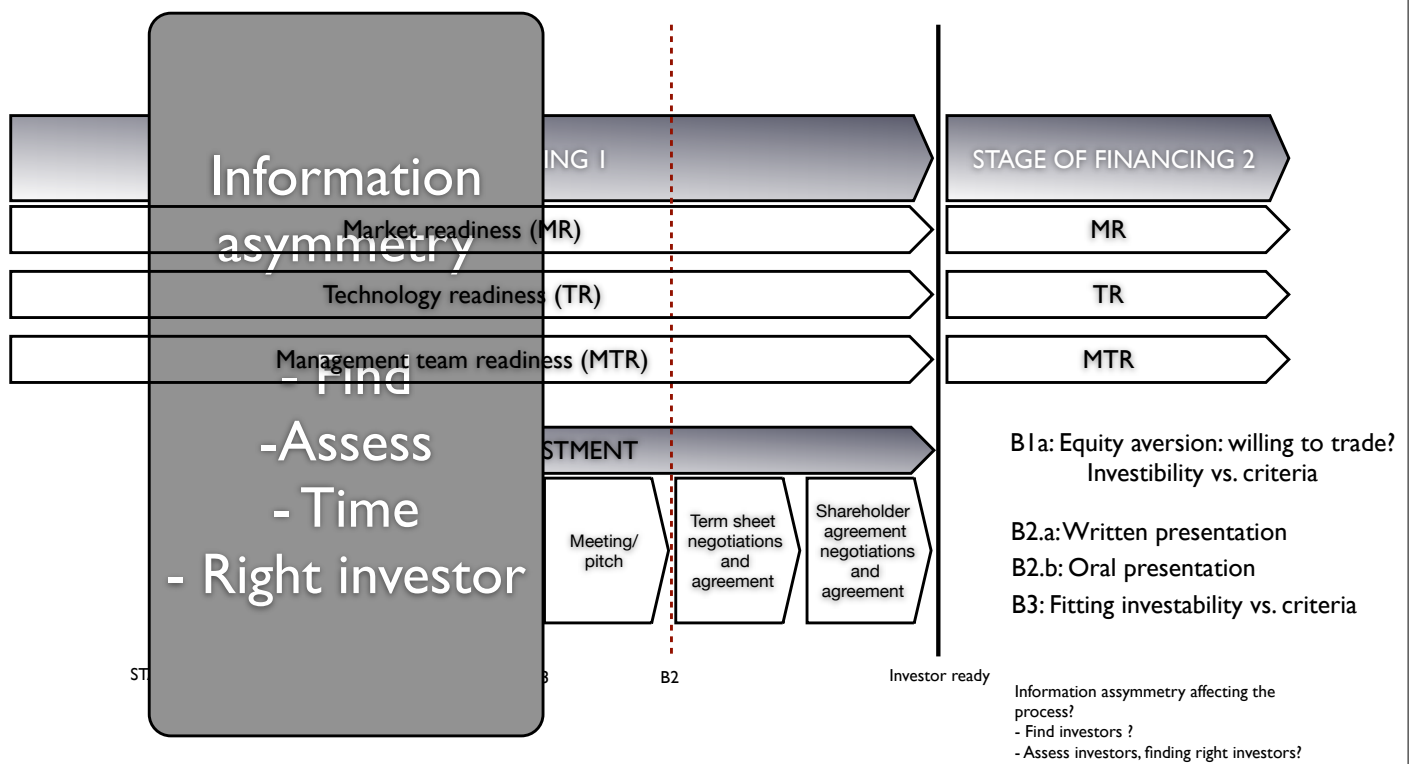
# Barriers



# Process Iterative



# Process Iterative



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## **B.2 Iterative Process**

- How to assess the the investment readiness?
- How to time the process?
- Equity aversion? How does that affect the process?
- Ability to find an investor willing to invest?
- Ability to find and assess the right investor?
- How do you get the right investor?
- What are your criteria?
- Do you experience information asymmetry?
- Able to know what the investor require?
- Have you met with investors?
- How did you carry out the process?
- How did you perceive their assessment of the investment readiness?
- Did it deviate from your assessment?



### B.3 Steps in the Investment Cycle

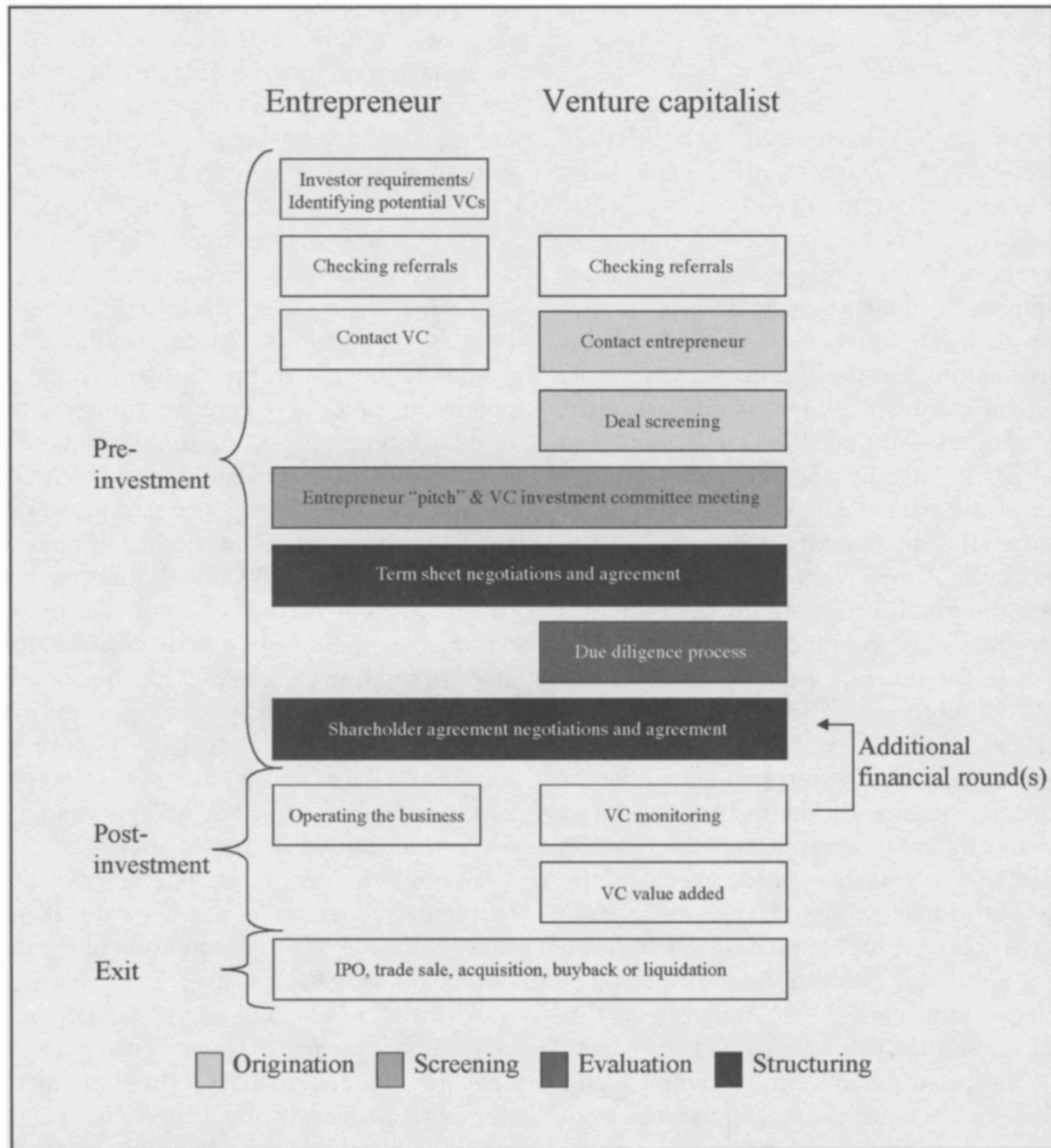


Figure B.6: Steps in the investment cycle. Source: Clercq et al. [2006]

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#### **B.4 Pre-investment Phase. Source: Clercq et al. [2006]**

- How to assess the the investment readiness?
- How to time the process?
- Equity aversion? How does that affect the process?
- Ability to find an investor willing to invest?
- Ability to find and assess the right investor?
- How do you get the right investor?
- What are your criteria?
- Do you experience information asymmetry?
- Able to know what the investor require?
- Have you met with investors?
- How did you carry out the process?
- How did you perceive their assessment of the investment readiness?
- Did it deviate from your assessment?