NTNU – Trondheim
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Venture Capital Trade Sales

Introducing the Acquirer's Perspective on
Venture Capitalists' Non-Financial
Value-Added

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Problem description

The purpose of this thesis is to gain a better understanding of how a company is developed with regards to trade sale exits.

The students will perform a qualitative multiple case study covering a series of previously performed venture capital trade sale exits.

Assignment give: January the 16^{th} , 2012.

Supervisor: Professor dr. polit. Roger Sørheim, IØT, NTNU

Preface

This written work is the master's thesis of the authors, who currently pursue a Master of Science degree at the Norwegian University of Science and Technology. The thesis is prepared for the course TIØ4945 - Innovation and Entrepreneurship, Master Thesis.

This thesis consists of theoretical findings from a literature review conducted during the fall of 2011 and empirical findings from interviews conducted during the spring of 2012. The interviews have touched upon sensitive information, so the case companies and actors involved have been made anonymous and the transcripts of interviews are not included.

The authors wish to thank their supervisor, Professor dr. polit. Roger Sørheim at NTNU, for invaluable assistance and mentoring during the work with this thesis. Dr. Sørheim's keen interest and continuous feedback has been highly valuable during the making of this thesis. All interviewees also deserve special thanks for setting a side valuable time in assisting the authors with this thesis.

This thesis still contains defects, but these are mainly due to the authors' own limitations.

Trondheim, June 5th, 2012

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Abstract

Research on venture capital has by large concluded that the venture capitalist (VC) adds non-financial value to his portfolio firms. The vast majority of venture capital exits are trade sales; and trade sales involves an acquirer spending a lot of effort on evaluating the portfolio firm. The acquirer has however not been given a voice in the research on the non-financial value created by the VC. This thesis contributes to research on venture capital by introducing the acquirer's perspective on how venture capitalists can add value to their portfolio firm. The thesis is paper based, with the main academic contribution inherent in the appended papers. The reader will be introduced to the field of research through this opening document. Paper one is based on a thorough literature review of both VC NFVA and M&A research and interviews with nine seasoned M&A actors. Paper two and three are based on three case studies of Norwegian trade sale exits, with the VC, the CEO and the acquirer as embedded units of analysis.

Paper one takes the first step to develop the acquirer's perspective by combining literature on the acquirer's due diligence (DD) process and empirical evidence from DD on entrepreneurial firms. The paper indicates how the VC can add non-financial value from the acquirer's perspective.

Paper two explores how the VC can create value for the acquirer through activities concerned with the motivation of the new venture team (NVT) to be acquired. The VC should keep a stern focus on both the intrinsic and extrinsic motivation of the NVT to create value from the acquirer's perspective.

Paper three looks closer at how the VC's effort in professionalizing the portfolio firm's standard of formal reporting systems and routines may contribute in reducing the risk associated with a trade sale. The VC should put in place formal control systems and routines to create value from the acquirer's perspective.

These papers have taken important steps to increase the understanding of how an acquirer values the efforts of the VC in a trade sale. This study is the first of its kind, and future researchers should continue to take use of the acquirer's perspective to create a more nuanced picture of how the VC can add non-financial value.

Sammendrag

Det aller meste av forskning på venture kapital har konkludert med at Venture-Kapitalister (VK) tilfører ikke finansiell verdi til sine porteføljeselskap. Meget ofte selges porteføljeselskap gjennom industrielle salg, noe som betyr at en oppkjøper broker mye ressurser på å evaluere de fleste sidene ved porteføljeselskapene. Disse oppkjøperne har derimot ikke vært en del av forskningen på det ikke-finansielle bidraget til VK'er. Denne masteroppgaven bidrar til forskning på venture kapital gjennom å introdusere oppkjøpers perspektiv på VK'ens ikke finansielle bidrag hos porteføljeselskapene. Masteroppgaven er artikkelbasert, men inneholder også en introduksjon for å gi leseren tilstrekkelig teoretisk kontekst for å følge artiklene. Artikkel en er basert på en litteraturgjennomgang av forskning på VK'ens ikke-finansielle verdiskapning og forskning på oppkjøp og sammenslåinger av bedrifter. De to siste artiklene er basert på tre case-studier av norske venture-støttede salg, hvor VK, entreprenør og oppkjøper er blitt intervjuet.

Artikkel en tar de første skrittene mot å etablere et oppkjøpers perspektiv på VK'ens ikke-finansielle verdiskapning gjennom å kombinere litteratur på selskapsgjennomgang (due diligence) og empriske bevis fra selskapsgjennomgang på entreprenørielle selskap. Eksisterende forskning på VK'ens ikke finansielle bidrag blir kombinert med oppkjøpers perspektiv, og artikkelen indikerer områder hvor VK bør fokusere innsatsen for å skape verdi for oppkjøperen. Artikkel to ser nærmere på hvordan VK'en kan skape verdi for oppkjøperen gjennom å motivere det entreprenørielle teamet. Artikkelen finner at VK'er bør fokusere både på indre og finansiell motivasjon for å skape verdi for oppkjøperen. Artikkel tre ser nærmere på hvordan VK'ens innsats for å profesjonalisere porteføljeselskapets formelle rapporteringssystem og rutiner kan bidra til å minske risiko forbundet med et industrielt salg. VK'en bør få på plass formelle kontrollsystem og rutiner for å skape verdi fra oppkjøperens perspektiv.

Artiklene har tatt viktige steg for å øke forståelsen av oppkjøpers perspektiv på VK'ens ikke finansielle verdiskapning. Denne studien er den første av dets slag, og fremtidige forskere bør fortsette å bruke oppkjøperens perspektiv for å skape et mer nyansert bilde av hvordan en VK bør være involvert i selskapene som han ønsker å selge gjennom industrielt salg.

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1 Introduction

Venture capital is a professionally managed pool of capital, investing their limited partner's money in high potential but high-risk companies (Sahlman 1990; Tyebjee & Bruno 1984; Zider 1998). The difference between a venture capitalist (VC) and other institutional investors, e.g. pension funds and insurance companies, is that VCs normally take an active role in the development in their portfolio companies (Steier 1998). VCs are involved with a variety of activities in the portfolio company to ensure that there will be a chance to exit the company and harvest generous gains. The research on the non-financial value-adding (NFVA) activities of the VC has become very popular among scholars researching venture capital (Large & Muegge 2008).

No matter what activities the VC perform, the home run for a VC is normally described as the initial public offering (IPO), and is thus the most researched exit vehicle (Schwienbacher 2005). However, the truth is that the vast majority of VC exits are trade sales, and under the current market conditions the importance of trade sales is growing (Gompers & Xuan 2009; Ernst & Young 2011). In a venture-backed trade sale, the acquiring company will evaluate every aspect of the targeted portfolio company before bidding. Among other things, the acquiring company will, directly or indirectly, make up their opinion of the VC's NFVA activities. Surprisingly, this perspective has not been included in the research on VC NFVA. The research is limited to three perspectives on how VC activities are linked to performance, namely the entrepreneur's, the VC's and the dyad between them (Ehrlich, 1994). This thesis aims to contribute to the research on venture capital by introducing a fourth research perspective on VC NFVA activities. Due to the growing importance of the trade sale exit, the authors of this thesis aim to contribute to the research on venture capital by introducing a fourth research perspective on VC NFVA, the acquirer's perspective. The thesis is paper-based, and the main academic contribution is to be found in the three papers included in the thesis.

In the next section of this opening document, we outline why we were motivated to immerse ourselves in the cross section between venture capital and M&A. We describe some of our motivation for this study by pointing at the importance of both trade sales and NFVA activities for academics as well as practitioners. To give the reader a sufficient context of where to place this academic work, the authors offer a brief introduction to research on both venture capital and mergers and acquisitions (M&A). Developing the acquiring perspective poses some methodological challenges, so we briefly touch upon the general considerations of the state of the art methodology. The authors also present a brief summary of the conclusions of each of the subsequent papers. Finally, the authors offer some implications for both practitioners and academics.

The reader should have the main focus on the appended papers. Paper one takes the first step to develop the acquirer's perspective and aims to investigate how VCs can add value to their portfolio firms from the acquirer's perspective. This paper is based on a thorough review of literature of both VC NFVA and M&A research and interviews with nine seasoned M&A actors. Paper two and three are based on three case studies of Norwegian trade sale exits, with the VC, the CEO and the acquirer as embedded units of analysis. Paper two aims to investigate how the VC can create value for the acquirer through activities concerned the motivating the NVT to be acquired. Paper three looks closer at how the VC's effort in professionalizing the portfolio firm contributes to reducing the risk in a trade sale.

2 Motivation of the study

The success of both the VC and the venture capital firm (VCF) is measured in the capital gains produced (Cumming & Macintosh 2003). However, practitioners seem to be deemed better at investing than existing (Wall & Smith 1997). Wall & Smith (1997) emphasize the importance of preparing for a trade sale, rather than having all the eggs in the IPO basket.

The troubles VCs experience when exiting can be seen through the current state of venture capital. During the last 15 years the United States (U.S.) venture capital has seen a dramatic increase in the total committed capital in the industry. In the mid-1990s the yearly total of committed capital amounted to $ 50 bn, increasing to an average of $ 250 bn in the period 2001-2008. In the same period, the venture capital industry posted average returns of 22 % per quarter (Ghalbouni & Rouziès 2010). However, venture capital's 5-year trailing performance has deteriorated from 48 % in 2000 to negative returns in the late 2000s (Kedrosky 2009). Despite heavy investment, VCs are unable to create enough exits, so successful exits are more important than ever for an industry in distress.

In terms of exit environment, the trends are showing less IPO activity with a relative increase in venture-backed M&As. In 2009 the US only saw eight venture-backed IPOs, and there were just three such events in Europe. Measured in realized returns per deal, venture-backed M&As are considered to be less profitable than IPOs (Capron & Shen 2007), but evidently very important to VCFs' success. In 2011 the total transaction value of IPO exits is estimated to be $ 5,4 bn, compared to a total transaction value of $ 71 bn in venture-backed M&A exits (Ernst & Young 2011).

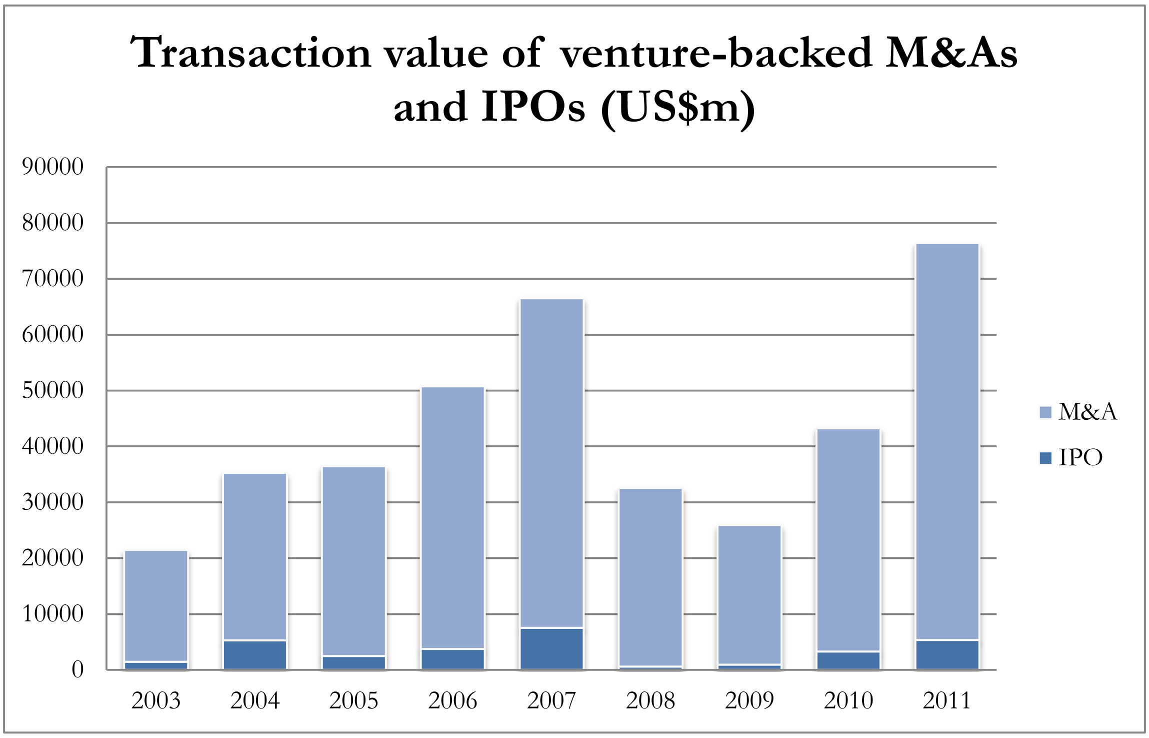

Figure 1: Transaction value of venture-backed M&As and IPOs.

There is a distinct mismatch between the importance of the trade sale for a VC, and the attention given to the trade sale exit by researchers and scholars in the venture capital field. Due to the publicly available data and the possibility of extreme returns, the IPO is the most empirically researched exit vehicle (Schwienbacher 2005; Dimov & Shepherd 2005). In addition, the M&A literature has also given limited attention to venture-backed acquisitions. This is not surprising since venture-backed M&As only constitutes a fraction of the total number of deals consummated: In 2006, in the U.S., about 10,500 deals were completed (Mergerstat 2011) - a significant number compared to the 386 venture-backed M&As in the same year (Ernst & Young 2011). Venture capital-backed acquisitions may seem less important to scholars researching M&A, but to those researching venture capital they are arguably very important. This argument is further backed up when considering the prevalence of trade sales versus IPOs and the fact that the liquidation event is the main event in the venture capital investment cycle and business model.

Since 2008 the amount of capital invested has been double of that raised, leading to a declining amount of available venture capital (Austin 2011). The lack of venture capital indicates that the venture capital industry to a larger extent needs to create winners from the existing list of portfolio firms. Several researchers have investigated the NFVA activities of a VC, but the field of literature is very fragmented and inconclusive, offering little guidance for practitioners (Large & Muegge 2008). The literature is limited to the perspectives of the VC, the CEO and the dyad between them(Ehrlich 1994), and the authors deem this to pose an interesting opportunity to add new perspectives to the existing research on VC NFVA. There seems to be an obvious link between the research on VC NFVA and what the acquirer looks for in a trade sale exit; If the VC concentrate his efforts on NFVA activities which do not create value or reduce risk for the acquiring company, it can be argued that the VC prioritizes incorrectly and should focus on a different set of NFVA activities. This connection intrigued the authors, and has created the backdrop for the study. By narrowing the scope of research to VC NFVA in a trade sale context, the authors hope to add value to two separate fields of research, both M&A and venture capital. When working with this thesis, the authors have always kept in mind that the study should create value for both practitioners and academics.

In summary, three observations became central in the development of and motivation to explore the research questions expanded on in the papers included in this master's thesis: (1) There is a distinct mismatch between the prevalence of trade sales and research on the topic. (2) Research on VC NFVA is limited to the perspective of the VC, the entrepreneur and the dyad between them, i.e. no effort has been made to include the acquirer's perspective on the matter. (3) M&A literature do not discriminate between DD processes on large companies and entrepreneurial ventures. With little done on these observations so far, it was quickly decided to make the thesis exploratory in its form.

3 An introduction to venture capital

Venture capital is a professionally managed pool of capital that is invested in equity-linked securities in private ventures that offer high potential return but high risk (Sahlman 1990; Tyebjee & Bruno 1984; Zider 1998). VCs can be categorized into three types. Namely corporate VCs, informal VCs, often referred to as business angels, and formal VCs (De Clercq et al. 2006). The latter is the most researched and will also be the focus for this thesis.

The typical VCF is organized as a limited partnership, with the VC serving as general partner and the investor as a limited partner (Sahlman 1990; Zider 1998). The general partners make the investment decisions, manage the VCF and will in most cases take an active role in the investment target.

The general partners raise VC funds by attracting capital from various parties; the largest percentage of the total fund size is most often invested by institutional investors (De Clercq et al. 2006) such as pension funds, insurance companies and financial firms. The amount of capital raised is usually at least US$ 100 million, but varies between firms. It is also common for VCFs to raise multiple funds over the lifetime of the firm, often managing several funds simultaneously. Due to the risk involved, the limited partners require an annual rate of return between 25 % and 35 % on the capital committed to the venture capital fund and that the fund should be terminated within a defined time frame, usually between seven to ten years. When the fund is terminated, all remaining capital and stocks are distributed to the investors (De Clercq et al. 2006; Sahlman 1990; Tyebjee & Bruno 1984).

Figure 2: Relation between Actors in a Venture Capital Fund

The capital which the VC raise is invested in entrepreneurial ventures whom approach the VCF with their ideas, are referenced through indirect or direct relation within the VCs' network (Shane & Cable 2002) or by other VCFs proposing to co-invest in a venture, known as a syndication. In a syndicate, one VC will usually take the role as a lead investor and take the main responsibility concerned with pre-investment due diligence and post-investment activities (Gorman & Sahlman 1989; Sahlman 1990; Zider 1998). The VC may also split the investment into several capital infusions, known as staging of capital (Gompers 1995; Gorman & Sahlman 1989; Wright & Robbie 1998).

If the VC decides to invest in a venture firm, the VC will typically claim in between 20 % to 60 % percent of the company's stock, determined by the maturity and stage of the venture firm. The average holding period for an investment is 4.9 years, although investments with payoffs higher than five times are held significantly longer than those who fail completely (Sahlman 1990). With a failure rate of 80 %, the VC will compensate for the risk inherent by demanding an annual rate of return of 60 % on the invested capital (De Clercq et al. 2006; Zider 1998). A portfolio company will eventually be exited, where trade sale and IPO are the most common successful exit vehicles. Any capital gain from the exit is immediately transferred back to the limited partners. However, only 10 % to 20 % of the VCF's portfolio companies need to be real winners in order for the VCF to realize these returns (Zider 1998).

As a utility to mitigate potential problems concerned with the principal-agent relationship between themselves and the VCs, the limited partners employ several mechanisms. E.g. incentives for mutual gain; general partners receive a success fee of 20 %, or 20 % over a predetermined level in addition to a management fee of 1-3 % of the capital of each fund (De Clercq et al. 2006; Zider 1998), specific prohibition of certain acts on the part of the VC which would cause conflicts of interest, limited life agreements and mechanisms to ensure that gains are distributed to investors (Sahlman 1990). The VC also have intrinsic motivation towards success as the possibility for the VC to raise new funds as well as attracting prospective venture firm investment deals in the future, is often contingent on the reputation from earlier affairs (Shane & Cable 2002).

4 The Venture Capital Investment Process

Tyebjee & Bruno (1984) described the decision process of VCs investment activity as an orderly five step process. Compared with Clercq et al. (2006), the first four steps are labeled pre investment and the fifth step is divided into a post investment phase and an exit phase. The following three subsections will combine the general categorization made by De Clerq et al. (2006) and the insights of Tyebjee & Bruno (1984) to give the reader an insight into the venture capital investment cycle.

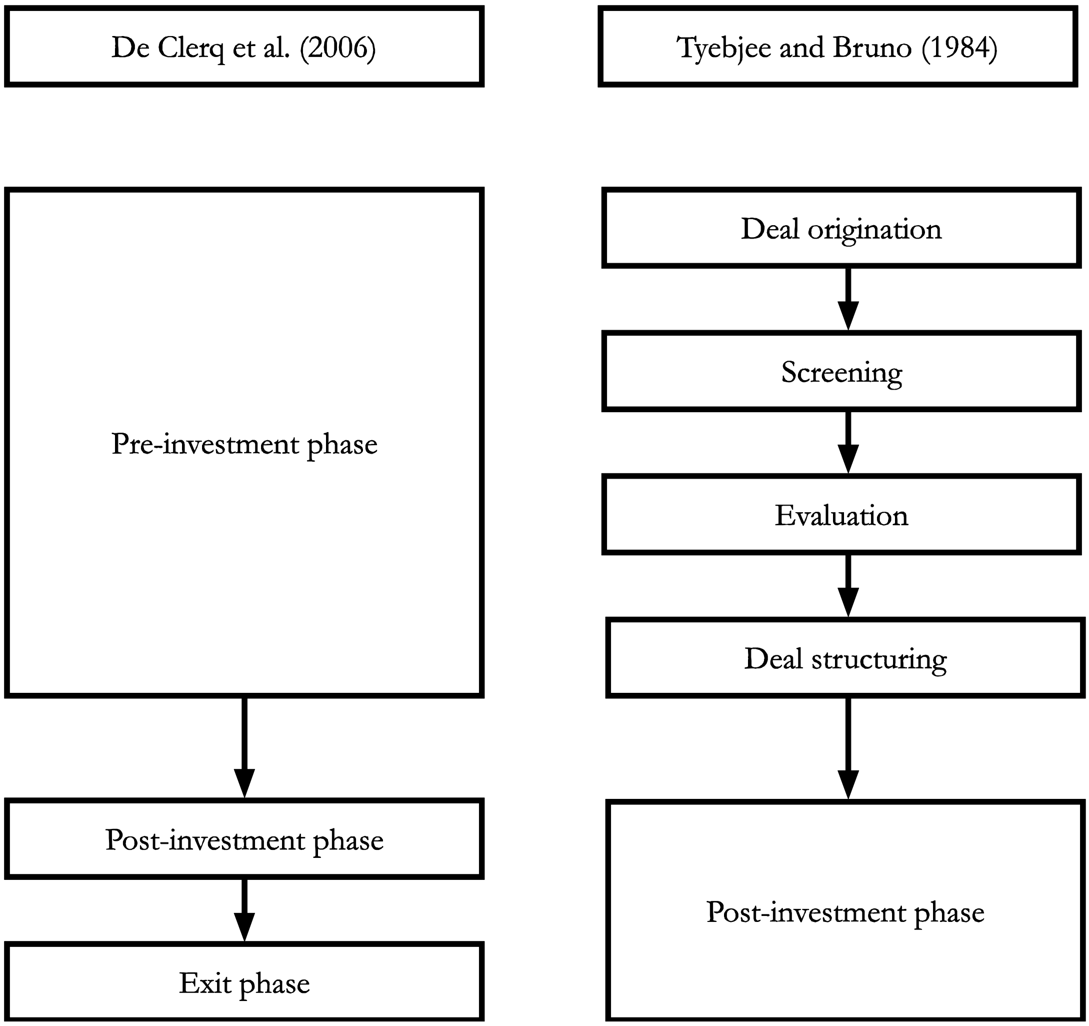

Figure 3: Decision Process Model of Venture Capital Investment Activity. Extracted from De Clerq et.al (2006) and Tyebjee and Bruno (1984).

4.1 The pre investment phase

The first step in the process is the deal origination. This is the step where the VCs become aware of potential deals. The major part of the VCs are passive in this process; potential deals are mostly referenced through network, acquaintances, prior investees or pitched by cold calls from entrepreneurs with no prior relationship to the VC. In some cases, the VC takes an active role in pursuing companies in the start-up stage and at the critical point of needing expansion financing (Tyebjee & Bruno 1984).

The VCs receive hundreds to thousands of investment proposals annually (Sahlman 1990; Zider 1998). With most VCFs typically having small staffs, the VCFs needs to screen through a vast amount of proposals, giving only brief attention to each, a process labeled screening in Tyebjee & Bruno's (1984) model. The time constraints mean they only invest in a fraction of the deals that come to their attention. To be able to filter out the potential winners, VCs employ some basic criteria the venture needs to qualify in order to be considered for next step in the process. The qualifying criteria in the screening phase, often indicate whether the venture is a fit or not for the VCF and are typically size of investment, industry stage, technology and market sector, geographic location and stage (Tyebjee & Bruno 1984; Zider 1998). Shane & Cable (2002) adds that social ties with, and especially the reputation of the entrepreneur have a large effect on whether the deal poses as a prospective investment opportunity or not.

Due to the fact that most ventures in search of capital have very little, if any, operating history, the VCs has to rely on a subjective evaluation procedure. Tyebjee & Bruno (1984) identified managerial capabilities, market conditions and how much the product or service differentiates itself as the criteria having the largest impact on the investment decision. Good managerial capabilities, associated with favorable references given to the entrepreneur, are the one criterion that has the strongest effect on reducing the perceived riskiness of the deal. By investing in areas with high growth rates, VCs primarily consign their risks to the ability of the portfolio company's ability to execute; in areas with high and accelerating growth rates it can be very hard to distinguish the eventual losing firms from the winners, thus the critical challenge is to identify competent management (Sahlman 1990; Zider 1998). Surprisingly, Tyebjee & Bruno (1984) found that the cash-out potential of a venture does not influence either perceived risk or return.

Once the entrepreneur and the VCF has decided that the venture is a fit, the deal will be consummated if the they are able to structure a mutually acceptable venture capital investment agreement(Tyebjee & Bruno 1984), a process labeled deal structuring. The agreement establishes the post investment valuation and the equity share the entrepreneur will give up in exchange for the venture capital. In addition, the VC usually structures their investment so they can keep firm control over the venture. The most important mechanism to enforce the control, is staging the infusion of capital. As result, the venture firm begins life knowing it has only enough capital to reach the next stage. Secondly, the VC creates compensation schemes that penalize the entrepreneur and employers holding stock, if poor performance is observed. Thirdly, the VCF will employ contractual rights in order to have downside protection. E.g. liquidation preferences, blocking rights, preferred stock and anti-dilution clauses. These mechanisms between VCs and entrepreneurs directly account for potential agency costs and the adverse effect of private information associated with high-risk, high-return projects. In addition to downside protection, the VCF may also give itself a favorable position for additional investment at a predetermined price, if the venture proves to be a winner (Gompers 1995; Tyebjee & Bruno 1984; Zider 1998).

4.2 The post investment phase

After the deal has been struck, the VC and entrepreneur enter the boat together, and the VC's tasks changes from due diligence and deal structuring, to value adding. The capital the VCF invest adds to the ventures value, and some research support that the VC also add non-financial value (Bottazzi et al. 2008; MacMillan et al. 1989; Sapienza 1992). The general perception in the venture capital research field seems to be that VCs can add non-financial value (Large & Muegge 2008). However, other research finds no evidence that VCs activities are linked to performance (Manigart et al. 2002; Steier 1998). Whether VCs add non-financial value to the firms in which they invest, has become the topic for several journal articles spanning the last 20 years (Busenitz et al. 2004; Ehrlich 1994; MacMillan et al. 1989). The articles mainly investigate two different questions: (1) What do VC's actually do after the investment and (2) to what extent can these actions be linked to performance? Researchers have used three different approaches to obtain empirical evidence for these general questions (Ehrlich 1994):

- Analyzing the situation from the VC perspective (Bygrave 1987; Gorman & Sahlman 1989; MacMillan et al. 1989; Rosenstein 1988).
- Analyzing the entrepreneurs' perspective on the value adding activities (Ehrlich 1994; Rosenstein 1988).
- Analyzing the dyad between the entrepreneur and the VC (Sapienza & Timmons 1989).

The listed research is not exhaustive, and concludes with varying activities where VCs adds non-financial value (NFVA) to the portfolio company. VC NFVA literature will be more thoroughly described in paper one, but in summary the VCs are found to create value through active involvement, among other by:

- Functioning as a sounding board for strategic decisions
- Functioning as a door opener through the VC's social and professional network
- Legitimating the company to third parties
- Monitoring the business' development
- Mentoring the CEO
- Assisting in the recruitment of executive management
- Giving financial advice

4.3 The VC exit

For a VC, the ultimate goal of an investment is to exit the investment and gaining a profit for both the limited partners and the partners in the VCF. The VC can exit their investment by one of the following five methods (Cumming & Macintosh 2003).

An IPO is often held as the home run for venture capitalists. In an IPO, the firm is listed on a stock exchange, which enables the sale of shares to members of the public. The IPO may be viewed as a way to generate funds for further growth (DeTienne & Chandler 2010), and gives access to additional funding without giving up control of the firm.

As an opposition to the retained control, the alternative is selling the portfolio company privately; an exit through trade sale. The motivation of the acquirer is often strategic (Cumming & Macintosh 2003), and the acquirer aims to create value that would not exist if the two companies operated separately (Haspeslagh & Jemison 1991). Trade sales are by far the most grossing exit route for the venture capital industry, comprising more than 90% of the exits for VCs (Ernst & Young 2011; NVCA 2012).

A less attractive exit vehicle for the VC is a secondary sale where the VC sells part of its equity to a strategic acquirer. Such an exit is viewed as inferior due to the lack of strategic premium an acquirer is willing to pay for less than 100% ownership (Cumming & Macintosh 2003). A secondary sale can also include full or partial exit by selling to other value creating investors like other VCs or PE funds.

VCs might exit their investment through buy backs, where the entrepreneurial team buys the VC's equity. This form of exit indicates that the VC views the company as less prospective, and the VC therefore wants to capitalize while they still can. The least attractive exit vehicle for a VC is a write-off. With this exit route, the VC determines there is little chance to harvest the initial investment and therefore refrains from spending any more time or other resources to aid the company.

5 The buy-side perspective of an acquisition

The three papers included in this thesis aim to shed new light on VC NFVA in a trade sale context. Trade sales involve strategic premiums and realization of strategic synergies and have been subject to vast academic attention. The authors therefore offer the reader an insight into the acquirer's context through a general introduction to the M&A literature.

5.1 Motives of the acquiring company

In a global and competitive world, companies can only earn anomalous returns if they enjoy unique and inimitable capabilities (Barney 1988), and large firms need to focus on internal innovation through research and development (R&D) (Baumol 2004). However, the R&D approach to radical innovation might be challenging since larger firms often struggle with innovating their resource base due to path dependency caused by self-reinforcing mechanisms inherent in the organization (Sydow et al. 2009). Consequently, many companies try to reinforce their resource base through acquisition of smaller innovative companies in possession of a specific asset, competence or capability. Young venture capital-backed companies often develop innovative technologies that can be exploited by existing technology companies (Gompers & Lerner 2001; Alvarez & Busenitz 2001). This is a strategy employed by many large technology firms including Cisco, Microsoft, Google, Facebook and Apple and has become even more important for large public companies as internal R&D budgets have declined in recent years (Gompers & Xuan 2009).

The literature describes a wide range of acquirer motives, and can be categorized in four major groups; Financial Motives, Strategic Motives, Operational Motives and Conflicting Motives (Bykvist 2008). An in-depth review of the motives in each group is outside the scope of this thesis, but following is a short explanation of the aforementioned categories.

Financial motives can be e.g. lower cost of capital. Put in a simple way: "(…) a large firm has cheaper access to capital than does a small firm" (Chatterjee 1986). Other motives are portfolio risk reduction, tax and disturbance theory (Bykvist 2008).

Strategic motives are often concerned with the concept of synergy, building on the resource-based view. An example is 'gaining access to raw materials and new competence'. The essential task in a strategically motivated acquisition is to create the value that would not exist if the firms operated separately (Haspeslagh & Jemison 1991). As such, companies are not only looking for past achievements, but aiming to create value in the future and pay a substantial premium due to the belief that extra value can be harvested (Sirower & O'Byrne 1998). This premium must, for the acquisition to create value, be of less monetary value than the synergies to be realized post-integration. Competence-based acquisition is a strategy often pursued by larger firms e.g. Siemens, ABB, General Electric and Nokia, and empirical findings show that competence-acquisition is a motive with increasingly importance and prevalence (Gammelgaard 2004). Other strategic motives include market power and defensive moves.

Operational motives are concerned with increasing revenue or reducing cost of operation, both easily explained by economic terminology or simply: earning more with the same expenditures or earning the same with reduced expenditures (Bykvist 2008). Reaching synergies through cost reduction subsequent to takeover are often emphasized (Gammelgaard 2004).

Conflicting motives is in opposition to the three other categories; they will not increase shareholder value, but relates to the decision makers in the acquiring company acting opportunistic. The motives can be explained by agency theory (Graebner & Eisenhardt 2004), e.g. a manager is motivated by his own vision for the company or is motivated by the prestige with managing a larger firm (Walter & Barney 1990). This aspect of the motivation is important because it reveals that managers on different levels might be responsible for driving the acquisition. The board of directors most likely has to approve the bid, but they are not necessarily the decision makers in an acquisition process.

5.2 Succeeding with M&A

The role of synergy realization and conflicting motives of the acquirer makes it a challenge to succeed with M&A, and these challenges increase in complexity when evaluating possible synergies related to acquiring operational-wise young venture-backed ventures. Due to information asymmetry and other complicating factors, such as the growth stage of the company and potential integration challenges (Kitching 1967), most of M&As do not create wealth for the acquiring company. 80% of the deals come up with big problems or just fail to create value (Yeheskel 2004), and shareholders should consider themselves lucky if they break even (Sirower & O'Byrne 1998).

An explanation to the high rate of failure might be attributed to the information asymmetry between seller and buyer in a trade sale. Compared to an IPO, where information is public due to regulatory requirements, information is harder to come by in private acquisitions (Capron & Shen 2007). To reduce the information asymmetry present in an acquisition, the acquirer is dependent on a substantial analysis of the targeted company, named due diligence (DD). The importance of the DD is shown through the huge advisory industry that assists acquiring companies with evaluating and estimating potential synergy effects and reducing information asymmetry (Laamanen 2007).

The DD process will be the subject of closer attention in the appended papers, but the acquirers in general go through the following DD processes prior to a trade sale (Picot 2002).

- Financial due diligence
- Legal due diligence
- Market due diligence
- Human relations due diligence
- Organizational due diligence
- Information technology due diligence

6 Methodology

This section covers more overarching reflections of the research process of this thesis. For a more specific and academic discussion expanding on research design and methods used, we direct the attention of the reader to the method chapter included in each of the appended papers.

6.1 Point of departure

The groundwork for this thesis was laid during the fall of 2011, when the authors were working on their project thesis: "A M&A perspective on venture capitalist's non-financial value-adding activities". The project thesis started out in the spirit of grounded theory, scouring scholarly journal articles for potential gaps and interesting research topics. Both the authors have been engaged in start-up companies with trade sale exit strategies. Consequently, as we became more knowledgeable of the academic efforts made to uncover VC NFVA activities, we were surprised that none had investigated the acquirer's perspective. Surely, the acquirer must be an essential piece of the VC NFVA puzzle? This was the question that intrigued us to further submerge ourselves in a literature review of both venture capital and the seemingly closely related M&A field.

From the outset, we aimed to contribute with insights to both academia and practitioners. In order to do that, we strived not to enter the gathering of empirical data with presumptions of what questions were interesting to ask. Instead, we followed an inductive approach where the data collected was formative in developing the overarching model presented in paper one. The data gathered and the model developed in paper one enabled the authors to narrow the scope in the case-specific interviews conducted in paper two and three. In these interviews the questions were more focused on the research questions the papers aimed at exploring, but still followed an open-ended format in line with inductive research.

6.2 Sampling

The sampling of interviewees can be split in two. The first group (A), shown in table 1, consists of 8 knowledgeable informants with experience from primarily the buy side, but also venture capitalists from the sell side. The second group (B), shown in table 2, consist of 9 informants linked to three specific cases and were interviewed after group A. We initiated contact with our informants either directly or via individuals in our personal network. The informants were also kind to reference other potential candidates.

Group A was sampled to give a general insight to the M&A field, and specifically to M&As of small and venture backed companies. It proved difficult to gain access to the persons responsible for acquisitions, an informant which was a prerequisite for a case to be eligible in group B. Three cases is a rather small sample, and the authors therefore wanted to gain as much insight as possible to the M&A process before doing the interviews with group B. Consequently, as a utility to be better prepared for the case-specific interviews, group A was also sampled to serve as a proxy to the case-specific triad made up by the VC, CEO and the acquirer in group B.

Pseudonym	***Position***	***Industry***
Cheetah	Partner	M&A Advisor
Puma	Executive Director	M&A Advisor
Jaguar	Associated Partner	M&A Advisor
Tiger	M&A Manager	Software and services
Leopard	Investment Manager	Private Equity
Panther	Self-employed M&A advisor / entrepreneur	N/A
Lynx	Partner	Venture Capital
Cougar	Partner	Venture Capital

Table 1: Non-case related interviewees

Case	***VC***	***Target company***	***Acquirer***
Thor	Lead investor	CEO	Managing Director
Odin	Lead investor	Founder CEO	VP Corporate Dev.
Frigg	Lead investor	CEO	Head of SBU

Table 2: Case-specific interviewees

6.3 Interviews

During the spring of 2012 we conducted in total 17 interviews. Five of the interviews were with VCs, four of them were with representatives from companies who had recently bought both venture- and/or non-venture-backed companies, three interviews were held with CEOs of targeted companies, three interviews were conducted with seasoned representatives in the M&A advisory industry and finally one interview was carried out with a private equity fund and a self-employed M&A advisor/entrepreneur, respectively. Also, 6 follow-up interviews were conducted of the VC and CEOs related to the cases in table 2. In total, these interviews lasted 12 hours and 13 minutes. All but one interview was tape-recorded; in the one that was not, the informant exercised his right not to be recorded, and notes were taken instead. All the other interviews were transcribed verbatim, totaling 119 single-spaced pages, and nearly 70 000 words.

The interviews were semi-structured and covered aspects idiosyncratic to the informant's expertise or experience. Interview guides were employed; however the interviewers encouraged the informants to speak freely. Both authors participated in all the interviews and the interviews with Norwegian informants were held in Norwegian. All quotes included in the papers were translated to English, and the authors strived so that nothing was lost in translation.

6.4 Information sensitivity

All the informants were also given the opportunity to cite-check their quotes. The feedback received is demonstrative of the immense secrecy and delicacy especially the acquirers put on acquisition processes, and proved to be a real headache to the authors. Several of the quotes sent were adjusted to be more 'politically correct', reducing their usability, while some quotes needed to be completely removed on the informant's request. One informant even stated that the quotes needed to be redacted due to legal reasons. This property was especially noticeable in the three cases describing venture-backed acquisitions included in paper two and three, and might be ascribed to the informants' fear of offending any of the other two linked parties that was interviewed. Taking the informants' perspective, the fear is not without reason. Paper two makes a point of the importance to the acquirer that the employees of the targeted firm join the acquirer's organization post-deal. Accordingly, the major part of the targeted company's organization is still employed with the acquirer and any accusations or negative comments might negatively impact the formal and or informal relationship of the linked informants. Although all informants were given pseudonyms, anonymizing their identity, any reader with intimate knowledge to the case would be able to realize which acquisition a case describes. This section adds to the authors' suspicion of why such studies have not been conducted before, namely the hardship endured in gaining access to reliable sources and informants. The reliability of the accounts given by the informants are also less since the information provided might have been subject to filtering and impression management.

6.5 Data analysis

The rich empirical data that was collected during the interviews was very exciting to the authors and proved to validate our methodological choice of including the acquirer. The data collected was supplied with secondary information from company websites, press clippings and other websites, e.g. LinkedIn and forums. Some participants in the interviews did not share a relation to each other beyond their idiosyncratic experience and expertise with M&As (Table 1, group A) while others were linked to a specific trade sale (Table 2, group B).

The research field has been highly exploratory, with no prior literature taking the acquirer's perspective in the VC NFVA setting. As a consequence, the authors had no prior methodological or theoretical principles to rely on. Group A was first analyzed cross case to create a map of possible research directions for the authors. Based on these interviews the authors were able to narrow the scope of the research, and develop a relevant line of questioning before the interviews on group B.

Paper one sets out to explore the acquirer's perspective of a trade sale, and as such, the authors pooled interviews with the nine acquirers from both group A and B to create the data set used in paper one. The interviews with the acquirers of group B therefore consisted of two parts, one case specific part and one general part. A cross case analysis on the data set led the authors to refine and adopt the DD process performed on large companies in M&As, described in the literature, to entrepreneurial companies.

Paper two and three uses a multiple case study to explore the triad between the NVT, the VC and the acquirer. The data collected from the case-specific interviews of group B were first analyzed within case, building rich and reliable cases of processes and relationships before and during the trade sales. Following the within-case analysis of the embedded units, we performed a cross-case analysis, which permitted the authors to find similarities and differences. Following this inductive approach, two papers were written based on the findings; how the VC can create value by influencing the NVT's motivation for a trade sale (paper two) and how the acquirer view the VC's effort in professionalizing the portfolio firm's formal control systems and routines, relating this to the financial DD performed on the company during the trade sale.

6.6 Limitations

This study is based on a sampling of 17 informants linked to three completed Norwegian trade sale exit process and eight knowledgeable informants with experience from primarily the buy side, but also on the sell side. As such, the results are not statistically significant. Due to the geographically small focus and meager representation of cases across several industries, the external validity of the thesis may be argued to be less and thus regarded to not be generalizable to the general population of venture-backed trade sales and DD processes in acquisitions of entrepreneurial companies. Although we took steps to minimize informant bias, we cannot be sure that we were not fed subject portrayals of accounts and events that may have affected our data, as described in the 'information sensitivity' section.

Most of the informants who contributed with empirical data in paper one were not case-specific, but relied on the informant's general knowledge and holistic view of the topics. Although we encouraged the respondent to relate any answers to factual events, we had no assurance that their responses were subject to bias and cross-event notions, i.e. in most accounts given we could not supply secondary data sources and could not involve any auxiliary informants due to the secrecy put on such issues. This adds to the limitation of paper one, since it reduces the reliability of the data and consequently the analysis and conclusions put forward.

Paper two and three also suffers from spillover from paper one since the empirical data and conclusions drawn in that paper was used as assistance when developing relevant questions for the three cases in paper two and three. Although we took steps to minimize any pre-conceived assumptions, this may have led the open-ended questioning to leave out aspects that might have been relevant. However, the authors considered this approach to be necessary due to the newness of the research conducted, as outlined in the previous section.

7 Summary of appended papers

7.1 Paper 1

7.1.1 Aim of the paper

The purpose of this paper is to take a first look at how a VC can add non-financial value to the portfolio firm from the acquirer's perspective, by answering the following two research questions:

> **RQ1:** How is the due diligence process on an entrepreneurial company?
> **RQ2:** Based on the acquirer's perspective reflected by the due diligence process on an entrepreneurial company: How can the VC create non-financial value in the portfolio firm?

7.1.2 Main Findings

The acquiring perspective of the trade sale is developed through a literature study of the due diligence made prior to the acquisition and nine interviews with seasoned acquirers and M&A advisors. By conducting a literature review of VC NFVA research, the authors are able combine previous research on VC NFVA with the acquirer's perspective developed by the authors. To the authors' knowledge, this is the first time that VC NFVA has been evaluated by use of the acquirer's perspective. Our findings concur with most of the existing research on VC NFVA, and agree that the VC adds value to the portfolio firm beyond financial investment. Specifically, our findings indicate that formal monitoring of the portfolio firm, recruitment, mentoring, aid with legal contracts and involvement in strategic decisions creates value from the acquirer's perspective. These activities enable the VC to positively influence the DD process that the acquirer runs prior to the acquisition. Positively influencing the DD process increases the VC's chance for a successful trade sale exit.

7.2 Paper 2

7.2.1 Aim of the paper

This paper explores how the VC can work with the NVT to overcome any conflicting motives related to the exit of the portfolio company through a trade sale, and how the acquirer value these efforts by the VC. The authors post the following research questions:

RQ1: How does the acquirer value the NVT in a trade sale?
RQ2: To what extent does active information gathering through a close relationship between the NVT and the VC, like for instance through a mentoring role, create value from the acquirer's perspective?
RQ3: How can specific information to the NVT about the intended exit strategy create value from the acquirer's perspective?
RQ4: How does a connection between the NVT and the acquirer create value from the acquirer's perspective?
RQ5: How do compensations schemes based on exit create value from the acquirer's perspective?

7.2.2 Summary of findings

The willingness of the team to be acquired is shown to be crucial for trade sale success. Two distinct factors of motivation for the NVT are identified. The VC plays a major role in contributing to the extrinsic (financial) motivation of the entrepreneur through the creation of value based compensation structures. At the same time the study indicates that the VC does not overlook the intrinsic motivation of the NVT, since this is a key element for the success in a trade sale exit. Mentoring, communication of intended exit strategy and facilitating meetings between the NVT and acquirer is found to have positive influence on the acquirer's perspective of the trade sale, and hence these activities are argued to be value-adding activities. The most important finding of this paper seems to be that the VC needs to be active in securing both extrinsic and intrinsic motivation. Failing to do so could turn out to be fatal when the acquirer comes knocking.

7.3 Paper 3

7.3.1 Aim of the paper

The paper explores how the VC can contribute with NFVA activities that prepares the investee for the crucial financial DD related to a trade sale of the company. The following research questions are sought answered:

> **RQ 1:** How does the VC contribute in professionalizing the venture-backed firm with regard to formal control systems and routines?
> **RQ 2:** How, if at all, do professionalization with regard to formal control systems and routines affect the financial due diligence process of the trade sale?

7.3.2 Summary of findings

Our findings indicate that the VCs passively contribute to the professionalizing of the portfolio firm's formal control systems and routines through the act of monitoring and control and by engaging in recruiting. The contributing mechanism in the former is indicated to be a feedback loop during reporting session, communicating whether the reporting is at par or inferior with the standards expected. The contributing mechanism in the latter is indicated to be the hiring of experienced executive management who bring with them their business acumen, systems of belief and who favors formal control systems - traits often not present in entrepreneurial teams with a scientific or technical background. Further, these NFVA activities positively affects the financial DD since high standard when it comes to internal reporting and accounting is associated with less hurdle and disruptions during the financial DD, reducing the acquirer's impression of risk in the deal.

7.4 Conclusions and Implications

The growing importance of trade sales and the characteristics of the VC as an active investor made the authors use this master thesis to investigate the non-financial value-adding of VCs in a trade sale context. For the first time to the authors' knowledge, the acquirer of a venture backed company is used to explore the non-financial value added by the VC.

Paper one is founded on a literature review of VC NFVA combined with the literature on M&A. The paper also included empirical data from nine interviews with seasoned M&A actors like the head of M&A departments and M&A advisors. Based on these empirical data, the theoretical work on DD is refined to fit onto the VC trade sale context, creating a state of the art perspective on VC NFVA activities and insights into how the VC can add value from the acquirer's perspective.

Paper two and three narrowed the scope in terms of the VC's activity, and used a multiple case study of three Norwegian venture-backed trade sale exits. Each case included interviews with the VC, the CEO and the acquirer. Based on these empirical findings, paper two investigates how the VC can create value by influencing the NVT's motivation for a trade sale. Paper three explores how the acquirer views the VC's effort in professionalizing the portfolio firm and how this affects the financial DD.

This thesis has taken important steps in linking VC NFVA activities with a trade sale exit. The authors hope that this thesis can form the basis for more studies on the acquirer's perspective of VC NFVA. The authors consider the acquirer's perspective to be crucial for a full understanding of how a VC should be involved in the portfolio firm beyond investing financial resources. Research-based knowledge within this field is likely to create value for VCs, entrepreneurs and acquirers.

7.5 Implication for practitioners

Through the last year, the authors have operated in the cross section between acquisitions and VC NFVA. The last six months have placed us in the unique position between all three parties involved in three trade sales. This position has given us the possibility to compare the three different perspectives, and have witnessed how the perceptions of the VC's NFVA activities vary. Along the way, the authors feel we have developed a sufficient understanding of our cases to give some advice to VCs.

The VC should keep the acquirer in mind throughout the investment period. VCs tend to check for potential exit routes and acquisition candidates prior to investment, but the VC should not forget the potential acquirers in the post investment phase. Technology is being developed in a raging speed, and this makes acquirers adapt to strategic challenges. Acquirers seem to have a strategic roadmap over the next years, and to become a potential acquisition candidate the VC has to ensure that the portfolio firm fits into the roadmap of the acquirer. A VC should early in his holding period seek out potential acquirers to make the portfolio company appear on different roadmaps. This will ensure that potential acquirers are aware of the portfolio firm, and at the same time give the VC valuable input to how the portfolio firm can become an attractive acquisition candidate.

The VC must motivate the NVT to be in it for the long haul. The trade sale exit puts a lot of value on the NVT. The acquiring companies emphasize the importance of the NVT, even though the acquisition might be strategically founded. The NVT must be both qualified and motivated. This broadens the spectrum of strings the VC has to play on to incentivize the NVT. The VC needs not only to motivate the NVT to the point of exit, but also through to the post-acquisition phase. From the authors' perspective, no trade sale will be successful before the NVT reaches a minimum of both motivational factors, meaning that a large financial incentive will not suffice to secure that the NVT is motivated for a trade sale exit. Solely focusing on financial motivation might even be harmful, because the acquirers often use financial incentives to motivate the NVT to join in after the trade sale. The acquirer might be unable to motivate the NVT to continue, causing the trade sale to fall together since the acquirer wants to be sure that the team stay on post-deal. The VC should therefore continuously focus on the intrinsic motivation of the NVT, and this effort is likely to payoff through a successful trade sale. The entrepreneur should also take note of this; a trade sale exit requires future commitment from the entrepreneur, and they cannot expect to simply walk away after a trade sale exit.

The VC should strive to document the operations in his portfolio firm. From the acquirer's perspective, the lack of documentation creates a lot of uncertainty in a trade sale. Having to find the information from scratch in a due diligence process can be very risky and cumbersome. The management of the target firm has to continue to run the company, and at the same time answer several potential questions and requests from the acquirer. This is a very stressful time, and might cause the NVT to make mistakes, which can impact on the transaction. Any sign of mistakes or inconsistency will make the acquirer scrutinize every aspect of the target firm, making the acquisition process longer and tougher than it needs to be. E.g. if the financial accounting and reporting standards of the portfolio firm is inferior with what expected by the M&A team with the acquirer, this may cause the deal to prolong, adding time and cost to both parties. In the worst case scenario the acquirer may walk away from the deal, since they are not able to build adequate models from the 'numbers', thus greatly increasing the risk associated with the deal. Additionally, if the deal is perceived as risky, the acquirer might negotiate earn-outs or contingent value rights, effectively delaying the payment for the acquired stock. Accordingly, the

VC should have a stern focus on formal reporting systems and routines in the portfolio firm, e.g. by recruiting a highly skilled CFO or by demanding high quality in the reports submitted from the management when monitoring the firm. As a reactive approach if such inadequacies are suspected, a vendor DD might mitigate some of the issues.

7.6 Implications for further research

Paper one took the first steps to a theoretically founded acquirer's perspective. The general M&A literature was reviewed, and size and age of the firm was found to largely influence the acquirer's considerations. The study has been highly exploratory, and future research should continue to shed light on the acquiring perspective through more elaborate studies on the considerations made when acquiring venture-backed companies. The papers contribute to research within both M&A and venture capital. From the venture capital perspective, additional insights are given on how the VC can add value to their portfolio company in the under-researched trade sale context. From the M&A perspective, the thesis has contributed to refining the DD process entrepreneurial firms are put through when an acquirer comes knocking on the door. Still, this field of research is in need of future research in order to further concretize and develop more robust models describing the DD process of entrepreneurial firms.

Further research on DD processes of entrepreneurial firms is needed. In 2006, the US had 10 500 mergers or acquisitions where 386 of them were venture backed. From our perspective, VC-researchers should not count on much assistance from the M&A research field when it comes to further development of the acquirer's perspective. We therefore recommend that venture capital researchers elaborate this research field on their own initiative, e.g. by exploring the transferability and applicability of the DD process outlined in the M&A literature to that conducted on entrepreneurial firms. There are still a lot of questions to be asked with regard to the interconnectedness of the different DD streams on an entrepreneurial company, especially how other DD processes influence the HR DD.

Future researchers should investigate how the DD process of high growth firms is related to industry. Looking at recent acquisitions, e.g. the acquisition of Instagram by Facebook for $ 1 bn and OMG Pop (creator of the mobile application Draw Something) that was acquired by Zynga for $ 210 mill, the DD process seem to be different than that described by the literature review in our study. How do the acquirers defend such phenomenal premiums paid on companies with a meager operating history and revenue? Are some elements special for the IT-industry? So far there is no theoretical perspective on such valuations or DD processes.

Future researchers should include the VC-NVT-Acquirer triad when researching VC NFVA. Paper two and three uses a state of the art methodology by including the acquirer's perspective of the VC NFVA. This research design provided valuable insights into VC NFVA activities. The authors appraise the primary contribution to future research to be the relevance of including the acquirer in the case studies. This created a state of the art perspective on the role of the VC activities, and future researchers should continue to include all the three parties involved in a trade sale to shed light on the non-financial value created. Even though the added perspective of the acquirer is important, the acquirer alone is not able to paint the full picture of the value created. The true value of this research design lies in the combination of the three perspectives of the VC NFVA. It would be very interesting to conduct a longitudinal study of several venture-backed companies that also included the acquisition process and the acquirer's perspective.

Keep in mind the methodological challenges. For researchers endeavoring on the same path as this thesis, the authors have made several experiences that can benefit future researchers in their methodological choices and procedures with regard to sampling and analyzing cases.

Firstly, the cases sampled for the study should be relatively fresh. This is not only due to the implication that the respondents are more probable to better remember the accounts leading up to and during the acquisition, but more importantly that the person responsible for the acquisition in the acquiring company might have been employed in new positions within or outside of the acquirer's organization after the acquisition has been consummated. This might implicate that the person in question is harder to get a hold of or is legally bound to not share any such information.

Secondly, the VCs, CEO and the entrepreneurs linked to the entrepreneurial company are easier to get a hold of. Therefore, the authors recommend future researchers to initiate contact with these persons first, and ask to be referenced to the acquirer. Since they have a history together, this facilitates the challenge of cold calling the acquirer.

Thirdly, acquisitions are an issue regarded as very sensitive and delicate, especially by the acquirer. Accordingly, researchers should stress that no party will be identified in the case descriptions and findings. In this thesis, the findings are presented case-by-case including quotes from all the informants. This design enables any party with intimate knowledge to easily 'break the code' and become able to identify what quotes belongs to which informant. Hence, to mitigate this problem, researchers conducting such case studies might go as far as not to relate any findings or discussions to specific cases and refrain from quoting. Obfuscating the empirical data from the interviews by synthesizing findings in general terms increases the entropy, rendering any data unintelligible. The gain might be more reliable accounts given the increased anonymity, although it might diminish the reliability of the study since no empirical evidence e.g. quotes, is provided. Future researchers should look more thoroughly into this challenging dilemma, in order to get valid data one might need to sacrifice the reliability of the study.

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Appendices

Appendix 1: Interview Guide M&A actors

General

- Name, position, experience, relevance for M&A
- Experience with entrepreneurial companies?

Acquisition process

- How is it initiated?
    - Top down vs bottom up?
    - Ultimate decision power?
- Who are the stakeholders?
    - Executive management
    - Mid-level management
    - Board of directors
    - M&A department
- Acquirer's motivation
    - Growth?
    - Cost savings?
- How are candidates discovered?
    - Presentations and arrangements?
    - Friend of a friend/word of mouth?
    - Media?
    - Advisory firms?
    - Mutual customers or partners?

Due diligence

- Areas of responsibility (NVT, VC, advisor, acquirer)
- Motivation
    - Red flags?
    - Plan integration phase?
- Documentation required?
    - Financial
    - Legal
    - Business Plan
    - Interviews within organization
    - Level of access?
- Potential deal breakers?
- Biggest fear?

- “Unofficial” information
    - Relationships
    - Networking
    - Legitimation role of a VC
- HR
    - Willingness to sell among the NVT?
    - Founder vs manager?
- Legal
    - IP?
    - Customers?
- Financial
    - Lack of operating history?
- Organizational
    - Organizational chart?
    - Post-acquisition integration?
- IT
    - Internal systems?
- Market
    - Only external?

Appendix 2: Interview Guide VC

Background information about interviewee

- Name/position/ experience
- Lead?

The Story

- The story from investment to exit
    - Rationale for investment?
    - Market outlook
    - Terms (equity share, syndication, board control)
    - Pre-planned exit strategy
        - Communicated?
    - Broker/VC driven exit process
    - Core value for the acquirer?

VC NFVA

- Level of involvement
- Contribution in addition to money?
    - Most important activities
    - Least important activities
    - Specific situations that shaped the future of the company?
- Disagreements (trade sale context)?
    - Specific situations!
- General decision process
- Trade sale exit in mind?
    - Exit strategy influence on activities?
    - Adapt or build a great company?
- Compensation structure
    - Financial incentive?
    - trade sale dependent?
- Monitoring structures
    - Corporate governance

Exit process

- Exit decision timing?
    - Who initiated? Seller or Buyer?
    - As planned?
    - Disagreements between NVT and VC?
    - Preferred exit route? IPO?
    - Time of communication to NVT?
- NVT motivation?
- Potential acquirer's
    - Degree of active marketing of the firm. How?

    - Prior relationship?
    - NVT perception.
    - NVT - preferred acquirer?
- Areas of responsibility (advisor/NVT/VC)
    - Price negotiations?
    - Providing data?
- Perception of the DD process
    - Degree of NVT-acquirer contact
    - Quality of data?
    - Efficiency?
    - Red flags?
    - Areas with extra attention?
        - NVT?
        - Financial?
        - Legal?
        - Organization?
        - Market?
    - Field visits?
    - Change in NVT perception of preferred acquirer?
- Role in the DD process
    - bridge builder?
    - VC-NVT relationship?

Appendix 3: Interview Guide Entrepreneur

Background information about interviewee

- Name/position/ experience
- Founder/Hired gun?

The Story

- The story from investment to exit
    - Market outlook
    - Terms (equity share, syndication, board control)
    - Exit motivation (Rich or King?)
    - Exit strategy
    - Broker/VC driven exit process
    - Core value for the acquirer?

VC NFVA

- Level of involvement
- How did VC contribute with except money?
    - Most important activities
    - Least important activities
    - Specific situations that shaped the future of the company?
- Disagreements (trade sale context)?
    - Specific situations!
- General decision process
- Trade sale exit in mind?
    - Exit strategy influence on activities?
    - Adapt or build a great company?
- Compensation structure
    - Financial incentive?
    - trade sale dependent?

Exit process

- Exit decision timing?
    - Who initiated? Seller or Buyer?
    - Disagreements between NVT and VC?
    - Preferred exit route?
- Potential acquirer's
    - How many?
    - Active search or contacted?
    - Prior contact?
    - NVT perception.
    - preferred acquirer?
- Areas of responsibility (advisor/NVT/VC)
    - Price negotiations?

    - Providing data?
- Perception of the DD process
    - Degree of NVT-acquirer contact
    - Quality of data?
    - Efficiency?
    - Red flags?
    - Areas with extra attention?
        - NVT?
        - Financial?
        - Legal?
        - Organization?
        - Market?
    - Field visits?
    - Change in NVT perception of preferred acquirer?
- Role of the VC in the DD process
    - bridge builder?
    - VC-NVT relationship

Appendix 4: Interview Guide Acquirer

Background

- Name/position / experience

General

- Acquisition motivation
    - Technology
    - Acqui-hire?
- Market outlook
- Initiation
    - Structured process?
- Prior knowledge of the target company
    - Operational history
    - Competitors?
    - Partners?
- Use of advisor
- Role of the VC
    - Link to DD
- Role of NVT
    - Link to DD

Due Diligence

- The story of the DD
    - Red flags
- Information quality
    - How was the information given
    - By whom?
- Areas with extra attention
    - NVT- perception?
    - Financial
    - Legal
    - Market/strategic fit
    - Organizational
- VC as a bridge builder?
    - Prior knowledge to the VC
- NVT contact points?
- Use of intermediary/advisor?
- Field visits?

Specific situations

- Based on the interviews of the related VC and CEO, specific situations where explained and the acquirer was told to comment. These situations are sensitive information, and are hence not included in this appendix

Paper 1

Venture Capitalist's Non-Financial Value-Adding in a Trade Sale from the Acquirer's Perspective

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Abstract

The venture capitalist (VC) investor is not just a source of financial investments for entrepreneurial firms. There has been a lot of research on the non-financial value adding (NFVA) by VCs, and the results show that there are VC activities that can be linked to value creation. However, the conclusions are solely based on the CEO and the VCs perspective on value creation. Successful trade sale exits are vital for any Venture Capital Firm, so it is surprising that the acquirer's perspective on the value added by VCs has been neglected. This paper aims to investigate the VC NFVA activities in light of the acquirer's perspective. The authors first develop an exploratory model relating VC NFVA activities and the due diligence (DD) process by conducting a literature review of both M&A and VC NFVA activities. A round of semi-structured interviews with 9 experienced representatives in both M&A departments of established companies and M&A advisors refines the model. These interviews clarify the considerations made by the acquirer when acquiring small growth companies, and more specifically the authors aim to answer the following research questions.

> **RQ1**: How is the due diligence process of an entrepreneurial company?
> **RQ2**: Based on the acquirer's perspective reflected by the due diligence process on an entrepreneurial company: How can the VC create non-financial value in the portfolio firm?

In general, the authors find that the DD process is dependent on size and age. Further, the authors concur with most of the existing research on VC NFVA, agreeing that the VC adds value to the portfolio firm beyond financial investment. Specifically, our findings indicate that formal monitoring of the portfolio firm, recruitment, mentoring, aid with legal contracts and involvement in strategic decisions create value from the acquirer's perspective. These activities enable the VC to positively influence the DD process that the acquirer runs prior to the acquisition. Positively influencing the DD process increases the VCs chance for a successful trade sale exit.

1 Introduction

At the heart of the venture capital business model is the successful exit from portfolio firms to gain generous returns both to the limited and the general partners. The most common successful exit routes are initial public offerings (IPOs) and trade sales. Due to the publicly available data, IPOs are the most empirically researched of the two (Schwienbacher 2005), although trade sales are more than twice as frequent (Cumming & Johan 2008). Figures from venture capital associations in Europe and the United States (U.S.) show that venture-backed trade sales are far more frequent than what found by Cumming and Johan (2008). Further, trends indicate that trade sales continue to grow in importance for VCs (NVCA 2012; Ernst & Young 2011; Gompers & Xuan 2009). There is a distinct mismatch between the importance of trade sales for venture capitalists (VC) and the attention given to trade sale exits in research on venture capital. Aligned with researchers like Gompers and Xuan (2009), the authors argue that academic efforts should to a larger extent focus on trade sales as an exit vehicle. This paper aims to increase the understanding of some of the constructs within 'the black box of trade sales'.

Unlike institutional investors, such as pension funds, insurance companies and financial firms, the VC play an active role in their investment (Steier 1998; Busenitz et al. 2004). Several researchers have investigated the involvement of the VC, and how this can be linked to value creation (see e.g. Gomez-Mejia 1990; MacMillan et al. 1989; Manigart et al. 2002; Sapienza 1992; Steier 1998). The general mentality among researchers seems to be that the VC is involved in non-financial adding (NFVA) activities(Large & Muegge 2008). The existing research is largely limited to using the perspectives of the VC, the new venture team (NVT) or the dyad between them to investigate and measure the value added (Ehrlich 1994). Through this paper, a different perspective of value added will be introduced, a perspective which is tailored to the trade sale context.

A successful trade sale exit is dependent on finding a suitable purchaser. Large organizations experiencing competition often acquire smaller entrepreneurial firms to stay competitive (Gompers & Lerner 2001; Baumol 2004). This has proved to be difficult, since up to 80% of acquisitions are considered a failure (Yeheskel 2004). To reduce the risk of bad investments, acquiring companies perform a thorough due diligence (DD) on potential acquisitions candidates. This DD process is important in the acquisition phase, being included in both the valuation of the venture firm and the negotiation process (Howson 2003). From a VC's perspective, the accentuation acquiring companies put on the DD process offer valuable insights. From the authors perspective, there seems to be an obvious link between the research on VC NFVA and the acquirer in a trade sale exit; If the VC concentrate his efforts on NFVA activities which do not create value or reduce risk for the acquiring company, it can be argued that the VC prioritizes incorrectly and should focus on a different set of NFVA activities. Hence, the acquirer's perspective should be included when investigating value added in a trade sale context.

In this paper the authors investigate this acquiring perspective on VC NFVA with a trade sale context. The authors set out to develop an initial model linking trade sale exits and VC NFVA. Our goal is to develop a model indicating where VCs can concentrate their efforts when planning to exit their investment through a trade sale. More specifically, the authors set forth the following research questions.

> **RQ1**: How is the due diligence process on an entrepreneurial company?
> **RQ2**: Based on the acquirer's perspective reflected by the due diligence process on an entrepreneurial company: How can the VC create non-financial value in the portfolio firm?

In order to answer these questions, an initial model based on an extensive literature study of VC NFVA and the DD process of the acquirer is developed. This is a highly exploratory field of research, since M&A researchers focus on larger acquisitions and venture capital researchers have mostly focused their effort on the IPO exit. Because of this exploratory nature, nine semi-structured interviews with highly experienced practitioners from various M&A actors provide the empirical foundation for which the initial model is grounded and adjusted.

The paper is organized as follows. Firstly the reader will be presented with the key considerations made by an acquirer prior to a trade sale. After presenting the trade sale context, the literature on VC NFVA is presented to show the how current research view the role of the VC in a portfolio company. Based on overlapping areas of the two fields of research, the initial model is developed. The authors will then present the empirical findings relevant to the improvement of the model, and finally present the final version of an exploratory model linking VC NFVA activities and the trade sale context.

2 Methodology

This paper consists of a literature review of the DD process in M&A and of VC NFVA activities with the aim of combining the two research fields into an exploratory model, depicting the links between them and how VC NFVA adds value to the entrepreneurial firm from the acquirer's perspective. As outlined in the next section, research on the DD of small or entrepreneurial firms is particularly in need for attention. Consequently, a multiple-case, inductive study involving 9 knowledgeable practitioners in the M&A field is performed. Such a multiple-case research design enables replication logic where each case is treated as an experiment, allowing for confirmation or disconfirmation of inferences drawn from the others (Yin 2009). The case study research design is likely to have strengths like novelty, testability and empirical validity and is particularly well-suited to new research areas for which existing literature seem inadequate (Eisenhardt 1989b), which is well aligned with this exploratory study.

2.1 Research setting and motivation

We chose the DD of entrepreneurial firms and VC NFVA as our research setting based on two discoveries made during the literature review. Firstly, the M&A literature does not discriminate on DD processes performed on larger more mature companies and the often smaller and younger entrepreneurial ventures. The finding that the M&A literature has not given attention to venture-backed acquisitions is not surprising since venture-backed M&As only constitutes a fraction of the total number of deals consummated: In 2006, in the U.S., about 10,500 deals were completed (Mergerstat 2011) - a significant number compared to the 386 venture-backed M&As in the same year (Ernst & Young 2011). Venture capital-backed acquisitions may seem less important to scholars researching M&A, but to those researching venture capital, they are arguably very important since the liquidation event is the main event in the venture capital investment cycle and business model. The importance of the latter is further backed up by the predominance of trade sales over other successful exit vehicles in the venture capital industry (Cumming & Johan 2008; NVCA 2012).

Secondly, the literature review of VC NFVA revealed that the research is generally limited to exploring the perspective of the entrepreneur, the VC or the dyad between them (Ehrlich 1994). The underlying logic of this paper is that the introduction of the acquirer's perspective to the VC

NFVA research might bring some clarity to the current inconclusive findings, as observed by Mason & Harrison (1999):

> Whether and in what ways venture capitalists add value continues to be a lively focus for debate, with no consensus on the answers.

Thus, the authors were motivated to take the first steps in developing a model bridging VC NFVA literature with M&A literature and by such view the different VC NFVA activities found by the numerous scholars who have research the field, from the lens of the party that actually associates a monetary value with them - the acquirer. The authors were motivated by the premise that this might give insights to what an acquirer looks for when acquiring entrepreneurial ventures and consequently add to the debate whether and in what ways VCs add value other than through capital infusions in a trade sale context.

2.2 Research scope and rational

As mentioned, this paper is based on a literature review of two research fields, namely M&A and venture capital, and an empirical exploration of the former. The multiple-case study was performed to confirm or disconfirm the applicability and transferability of the DD processes, outlined in the M&A literature, to acquisitions of entrepreneurial firms; it is reasonable to expect that the DD process differs since entrepreneurial ventures exhibits distinctive differences when comparing them to mature firms with longer operating history and a more clearly defined organization, financial structure and market size (Ragozzino & Reuer 2007). Also, the acquisition of mature companies might be motivated by a different logic (e.g. hostile takeover, conglomeration) than the logic behind acquiring entrepreneurial firms (e.g. access to new technology). The authors expected these characteristics to be reflected in the way the DD is performed on entrepreneurial firms. Thus, the rationale behind performing a multiple-case study of the DD process of entrepreneurial firms in the M&A setting, and not on VC NFVA activities that constitutes the other part of this paper, is grounded in the necessity to develop a 'toolbox' - the DD performed on entrepreneurial firms - from which the VC NFVA activities previously found by scholars can be operationalized. The literature on VC NFVA is extensive and the authors did not view an empirical exploration of this domain to conduce any new insights of importance to this paper. Accordingly, the scope of the paper is to put current research of VC NFVA activities into the context of the DD performed on entrepreneurial firms, not validate whether a VC NFVA activity is grounded in factuality or not.

2.3 Sampling

Given our research question about how the DD process is performed on a small company, we sampled nine knowledgeable persons who either had experience as the person responsible for one or several acquisitions or as an advisor in such deals. Highly influential and knowledgeable informants are considered to be the most reliable and are particularly so when recalling recent important events (Kumar et al. 1993; Huber & Power 1985). The sampling of informants mainly followed a 'snowball approach', where one informant referenced us to another. We did not employ any particular constraints in the sampling, other than that the informant should have deep knowledge and experience with acquisitions and preferably with venture-backed.

Pseudonym	***Position***	***Industry***
Cheetah	Partner	M&A Advisor
Puma	Executive Director	M&A Advisor
Jaguar	Associated Partner	M&A Advisor
Tiger	M&A Manager	Software and services
Leopard	Investment Manager	Private Equity
Panther	Self-employed M&A advisor / entrepreneur	N/A
Snow Leopard	Managing Director	Software / Hardware
Lion	VP corporate Dev.	Software
Mountain Lion	Head of SBU	Hardware

Table 1: Overview of informants.

2.4 Data sources and analysis

The study is based on several data sources: (1) qualitative data from semi-structured interviews with experienced practitioners the M&A field. (2) archival data, including company websites and press clippings.

We conducted nine interviews with our key informants, varying in length from 30 to 50 minutes following an interview guide based on an extensive literature review of M&A and venture capital, and Picot (2002) overview of the five sub-analysis in a DD in particular. The interviews followed a more open-ended format, with questions that were idiosyncratic to the expertise of the informant. During the interview, we encouraged the informant to relate answers to facts and actual events, rather than on the respondents' interpretations, reducing the probability of the information provided being subject to cognitive biases and impression management (Golden 1992; Huber & Power 1985; Miller et al. 1997). Acquisitions and trade sales are a delicate matter to the parties involved, especially the five acquirers interviewed. Consequently, to motivate our informants not to hold back on information, we promised confidentiality (Huber & Power 1985; Miller et al. 1997; Yin 2009).

After all the interviews were complete, they were transcribed verbatim, totaling 61 single-spaced pages, coded and grouped in categories based on Picot's (2002) overview of the five sub-analysis that a DD should include. The process was formative in gaining a practical understanding of the acquisition process in general and of venture-backed firms in specific. Through replication logic, similarities and differences in acquisitions of entrepreneurial companies and more mature ones emerged. Since the study is exploratory in its form, short follow-up interviews was performed with several informants to provide a 'sanity check' of the developed model on DD of entrepreneurial firms and the argumentation behind it. This ensured a closer relationship with the exploratory model developed in the discussion and the world as perceived by the practitioners.

2.5 Literature Review

The literature review started out with a broad approach with the objective of locating key articles placed in the center of reference and citations. After gaining a better understanding of the two fields of research, two approaches were applied to further explore the available literature. Core articles were used as a starting point to apply the snowballing sampling approach, i.e. reviewing relevant articles cited in the core articles and applying the technique recursively on the new articles found. This approach is limited to looking at articles backwards in time, and the approach was therefore complemented by searching for distinct keywords, terminology and key phrases in online databases, extracted from the snowballing approach.

The preferred online database for literature research has been ProQuest AB/Inform, ProQuest Entrepreneurship, JStor Complete and Google Scholar (GS). The advantage of using GS is the supreme search algorithm and the vast amount of indexed articles and databases. Nevertheless, GS has some limitations when compared to the three peer-reviewed databases. GS has deficiencies with basic boolean search operations, does not have any sort options (beyond the questionable relevance ranking) and is criticized for its secrecy concerning which databases are crawled, and the update frequency of those who are crawled (Jacsó 2008). As a mean to mitigate the limitations in GS, the aforementioned peer-reviewed databases was preferred as a source to obtain relevant articles in addition to acting as a source to obtain full-text articles indexed, but not available, in GS.

2.6 Limitations

This study is based on a sampling of nine knowledgeable informants with experience from primarily the buy side. As such, the results are not statistically significant. Due to the geographically small focus and lack of acquisitions across several industries, the external validity of the study may be argued to be less and thus regarded to not be generalizable to the general population of venture-backed trade sales. Although we took steps to minimize informant bias, we cannot be sure that we were not fed subject portrayals of accounts and events that may have affected our data: The lion's share of informants who contributed with empirical data in this paper were not related to any specific cases, but mostly relied on their general knowledge and holistic view of the topics. Although we encouraged the respondent to relate any answers to factual events, we had no assurance that the responses were subject to bias and cross-event interpretations, i.e. in most accounts given we could not supply secondary data sources and could not involve any auxiliary informants due to the secrecy put on such issues. This adds to the limitation of the paper, since it reduces the reliability of the analysis and conclusions put forward.

The venture capital industry has experienced tremendous change over the past decade, and the academic research has not yet been able to catch up to reflect this. The authors have therefore reviewed a large span of articles from several fields and many different journals, including recent unpublished work and non-academic sources. A more appropriate academic approach would be to reduce the article population by ranking and selecting articles in accordance with e.g. the Financial Times rankings and the ESSEC classification. The authors believe that using this method would put too many constraints on the article population and by such reduce the theory pool available to shed light on the M&A perspective of VC value adding. This argument is supported by Bruce (2001), who states that "(...) students working on relatively new research areas need to read even studies that are of peripheral interest (...)" Nevertheless, the use of articles from lesser ranked journals and unpublished sources might add to limitations in the literature review, thereby reducing the construct validity of the paper (Yin 2009).

3 The Acquirer's perspective

Most of M&As does not create wealth for the acquiring company. 80% of the deals come up with big problems or just fail to create value (Yeheskel 2004), and shareholders should consider themselves lucky if they break even (Sirower & O'Byrne 1998). As an explanation to the high rate of failure, some researchers point to the information asymmetry between seller and buyer in a trade sale (Lusch & Harvey 1998; Ragozzino & Reuer 2007).

Compared to an IPO, where information is public due to regulatory requirements, information is harder to come by in private acquisitions (Capron & Shen 2007). To reduce the information asymmetry present in an acquisition, the acquirer is dependent on a substantial analysis of the targeted company, a DD. The importance and complexity of DD is shown through the huge advisory industry that assist acquiring companies with evaluating and estimating potential synergy effects and reducing information asymmetry (Laamanen 2007). The DD process will be both decision critical and a determinant of valuations (Angwin 2001; Harvey & Lusch 1995; Perry & Herd 2004), so an insight into the DD process is important to paint the full picture of the acquirer's perspective. The next section presents a review of the considerations made by the acquirer in a DD process to establish the acquirer's perspective.

3.1 Due diligence on private companies

> Due diligence should be a comprehensive analysis of the target company's business—its strengths and weaknesses—its strategic and competitive position within its industry (Kissin & Herrera 1990).

As already mentioned, the success rate of acquisition is very low. Building on this empirical fact, Perry and Herd (2004) calls for going beyond traditional DD to performing a detailed value assessment before signing a memo of understanding. By employing a more detailed assessment of the target company, Perry and Herd (2004) concludes a buyer is more able to quantify likely cost to implement the acquisition (both expenses and capital), and estimate the time it might take to realize the benefits. The comprehensive DD should make the acquirer able to understand the risk associated with purchasing the company, and the acquirer's DD findings are used in the price negotiations (Angwin 2001). With this in mind, Perry and Herd (2004) hypothesize that the improved DD should influence what the acquirer should pay for the target. The importance of the DD in valuation is supported by Howson (2003) who states that skeletons found during a DD can work as negotiation points to the acquirers benefit.

Picot (2002) gives an overview of the DD process, and introduces different DD-streams that should be performed by the acquirer. The authors uses these sub categories as the basis for presenting the theoretical view on important considerations made by the acquirers in a trade sale, in that manner establishing the acquirer's perspective.

3.1.1 Financial and Legal due diligence

Financial DD is focused on the financial numbers of the company being acquired. The focus is not only to uncover the financial past, but also to make sure the financial structure is sustainable (Howson 2003). The financial DD stream supplies the acquirer with information that enables them to project future growth and earnings, and the accuracy of the numbers are critical for the acquisition (Harvey & Lusch 1995). Within the financial aspect, certain companies are looking for a minimum amount of revenue and industry multiple in order to consider purchasing the company (Rao et al. 1991) - an indication that size of the company plays a role in an acquisition. The financial DD often pose a 'go' or 'no-go' conclusion for the acquirer (Harvey & Lusch 1995).

Legal DD is focused on looking over the contracts the organization has signed to make sure there are no future surprises with unexpected liabilities (Picot, 2002). Personnel and supplier contracts are especially scrutinized, and when looking at personnel contracts, the transferability to the acquiring company needs to be investigated (Harvey & Lusch 1995).

3.1.2 Market due diligence

Market DD looks to validate the premises on which the selling company's business strategy is based. Particularly important in the market evaluation is to find the relative market share and market stability (Rao et al. 1991). The market DD is trying to get a glimpse of the future and see possibilities and risks, it is important to scan the macro environment to evaluate the applicability of company's historical data (Harvey & Lusch 1995). Some researchers argue that this stream of DD should precede any other in order to create a list of acquisition candidates based on a systematic industry assessment (Lusch & Harvey 1998). Howson (2003) point out that market DD need to uncover a strategic fit, meaning the products of the analyzed company should complement the product portfolio of the acquiring company (Rao et al., 1991). Laamanen (2007) supports the importance of the product line and product development in a trade sale, by concluding that efforts within R&D to be positively related to the premium paid in an acquisition.

3.1.3 HR due diligence

HR DD is an attempt to uncover the human and social capital in the organization (Picot, 2002), through an in depth evaluation of the strengths and weaknesses of the key executives (Harvey & Lusch 1995). Due to the risk of key managers leaving, it is crucial to find how the organization's employees will respond to a takeover by looking into the attitude of managers and the corporate culture (Picot 2002; Hall 1993; Hall 1992). This is important because personnel compatibility is found to create the possibility for further prosperity after an acquisition (Graebner 2004). The importance of the management team is further underlined by Capron & Shen's (2007) observation that private acquisitions are done to expand the competence of the buyer within an industry, as opposed to entering new industries where acquisitions of publicly traded companies are preferred. This observation is aligned with the view of the entrepreneurial team as a resource in itself (Garvis & Ireland 2002). Rao et al. (1991) validates that acquirers also believe this; by concluding that fit in management style is important when doing a DD. Even if all other factors were positive, resistance from the management team is still seen to be a deal breaker (Rao et al. 1991).

3.1.4 Organizational due diligence

Organizational DD focuses on the whole organization to see if it is properly build in regards to size and both procedural and hierarchical efficiency (Picot, 2002). It is an investigation of the responsibilities of the different departments and it aims to understand the decision making process (Rosenbloom 2002). The organizational DD is also important to avoid clashes in the decision making culture and other aspects of the organizational cultures. The assessment should also review the control systems in place to monitor operations (Harvey & Lusch 1995). In other words, the DD aims to find out if the organization is balanced and how the working processes are managed, e.g. inventory control (Harvey & Lusch 1995).

3.1.5 IT due diligence

IT is now regarded as one of the most critical aspects of integration and successful implementation of acquired firms (Popovich 2001; Harvey & Lusch 1995). Besides employees, IT infrastructure is the largest investment for most firms, and early and detailed IT planning can make an acquisition unfold more smoothly and realize synergies faster (Boomer 2011). In a study on post-merger management Sarrazin & West (2011) found that 50 to 60 percent of the initiatives intended to capture synergies were strongly related to IT, further supported by the fact that some large M&A advisory firms, such as PWC, offer IT DD services to their clients.

4 The VC NFVA context

The reader now has a better understanding of how a trade sale elapses from the acquirer's perspective, and what they deem to be important in a trade sale. The authors will in the following section summarize their findings from an extensive literature review of VC NFVA activities. The literature on VC NFVA is very fragmented (Large & Muegge 2008), so the authors have developed their own categories of VC NFVA activities. These categories are simply designed to make it easy for the reader to see the connection between VC NFVA activities and the acquirer's perspective. Based on the literature review, the authors are able to develop an exploratory model that indicates where a VC can add non-financial value from the acquirer's perspective.

4.1 VC NFVA activities

4.1.1 Strategic decisions

Several researchers conclude that working as a sounding board for strategic decisions is the most important non-financial value added by VCs (MacMillan et al. 1989; Rosenstein 1988; Sapienza & Korsgaard 1996; Wijbenga et al. 2003). Gorman & Sahlman (1989) emphasize the consulting role of the VC, indicating that they act on a need-to basis. This kind of mentality is supported by research on the Swedish VC industry (Fredriksen et al. 1997).

The view on the importance of VC involvement in strategic issues is split. Through in-depth interviews of CEOs and VCs, Gomez-Mejia (1990) found that the VC and the CEO disagree on the importance of the VC in strategy formulation. On one hand, the VCs look at strategy formulation as very important and wish to participate in this activity, but on the other, the CEOs do not view this effort to be of high value. The VC exercises his influence on strategy formulation primarily through his presence on the board of directors; boards in venture-backed companies are recognized to be more active in VC-backed companies than in others (Gabrielsson & Huse 2002). The VC might also take a more informal approach to affecting the strategic decisions through 'strategy sessions' and phone calls (Gomez-Mejia 1990).

4.1.2 Network and legitimation

The network the VC brings to the investee has been shown to be a significant value-adding asset (Wijbenga et al. 2003). Firstly, the network acts as a source to locate potential additional investors (Gomez-Mejia 1990; Gorman & Sahlman 1989; Timmons & Bygrave 1986), which may also alleviate the asymmetric information inherent in a trade sale. In their study of 1,261 acquisitions of venture capital-backed private companies, Gompers & Xuan (2009) finds strong evidence that venture capital firms can form a bridge between acquiring firms and target firms that reduces asymmetric information associated with the transaction. Specifically, an acquisition was found to be 3.8 times more likely to take place when there was a common venture capital investor linking the acquirer and the target. However, a recent working paper (Gompers et al. 2012) shows that when VCs syndicate their investments they exhibit strong detrimental homophily in their co-invest decisions, i.e. they choose to co-invest with VCs with the same background and skills as themselves causing e.g. group thinking. The paper's preliminary findings point out that in some cases displaying this selection property, the probability of investment success is lowered by 25 %, which emphasizes the value of an extensive and varied VC network.

Secondly, the network helps to establish long-term relationships with industry participants (Sapienza & Timmons 1989; Ehrlich 1994). These points support the conception that VCs with experience and knowledge within the portfolio company's industry is more active and provide more value than VC generalists (Bottazzi et al. 2008; Sapienza & Korsgaard 1996; Sætre 2003). However, the research is not specific in whether or not the VC actively build network to the benefit of specific portfolio companies, or if the VC build his general network within an industry.

In the spirit of Burt (2000), being mentioned as a portfolio company of a VCF might provide the company with easier access to resources both within and outside of the VC's network. This can be related to the credibility a portfolio company gains after the infusion of venture capital, especially if the VCF has a reputable history (Timmons & Bygrave 1986). The legitimation role of the VC also comes to show when VC-backed companies go public. Research reveals that underpricing in IPOs are less common compared with non-venture-backed companies, even though the performance is not significantly different (Belghitar & Dixon 2012; Cumming & Macintosh 2003; Megginson 1991). In trade sales, the acquirer is acknowledged to better resolve information asymmetry through DD than that of a group of disparate shareholders in an IPO. Consequently, the legitimation role of a VCF is of greater importance when exiting ventures by an IPO, than by an acquisition (Cumming & Johan 2008). However, it seems as legitimation is an important NFVA activity for VCs exiting through trade sales since they are 'staking their reputation' on not selling overvalued assets (Gompers & Xuan, 2009), although VCs have been found to display a rent seeking behavior when liquidating their investments (Kamath & Yan 2010).

4.1.3 Monitoring

The monitoring process is one of the most specific tasks described in the VC NFVA literature (Ehrlich 1994; Gomez-Mejia 1990; MacMillan et al. 1989; Sweeting & Wong 1997). The VC is involved with both formal monitoring through a seat on the board of directors and informal arenas like phone calls (Gomez-Mejia, 1990). The VC also requires formal documentation like monthly financial reports from the entrepreneurial team to monitor progress (Gomez-Mejia 1990; Rosenstein et al. 1989) and sets high performance standards for their investments (Rosenstein 1988; Ehrlich 1994), and provides feedback if the reporting or performance is inferior with the VCs expectancy (Ehrlich, 1994).

Monitoring is a prime example of agency-principal theory (Eisenhardt 1989a) where the VC is the principal struggling with informational asymmetry towards the entrepreneurial team as the agent. Formal monitoring becomes crucial for VCs to combat the lack of information (Sahlman 1990; Shane & Cable 2002). Even though the portfolio company incurs opportunity costs through the work with the documentation it is required to give the VC, the VC is concerned that the entrepreneurial firm might act opportunistically if they don't monitor them (Gompers 1995). Yet, the VC is cautioned to not exercise this monitoring covenant excessively since employing monitoring rights might have a negative effect on the VC-CEO relationship (Sahlman 1990), which is found to be destructive for other VC NFVA activities (Sapienza 1992; Busenitz et al. 2004).

4.1.4 Financial advice

The 'financial advice' category is closely related to above category since monitoring often is focused on financial reporting. However, we include financial advice as a separate category since it describes a VC NFVA activity that often coexists with monitoring, but are not necessarily mutually inclusive.

In a qualitative round of interviews performed by Gomez-Meija (1990) all participating CEOs praised the financial advice given by the VC, e.g. helping with financial management, structuring the financing of the firm and legal contracts, a finding later supported by Sapienza & Korsgaard (1996). Moreover, Ehrlich (1994) found the VC to assist the entrepreneur in establishing internal managerial systems and controls, indicating a more active approach to financial advising. These findings are quite specific, and not surprising from a resource based perspective (Walter & Barney 1990) since the financial experience might be lacking in entrepreneurial teams and especially in teams consisting of entrepreneurs with a strong technical or scientific background (Ehrlich, 1994), and at the same time it is one of the core competences of a VC.

4.1.5 Mentoring

The need for monitoring of portfolio companies has been found to decrease with the quality and closeness of the VC-NVT relationship (Gomez-Mejia 1990; Gabrielsson & Huse 2002). By the use of procedural justice theory (Sapienza & Korsgaard 1996), the agency-theory's conclusion about the need for monitoring is challenged. A personal relationship is found to give the VC a 'relationship power', enabling the VC to influence the CEO through e.g. late night dinners (Fried & Hisrich 1995). VCs often use this relationship to assume a mentoring role in the VC-CEO relationship, providing the CEO with e.g. interpersonal advice in matters other than business related (Sapienza 1992; Sapienza & Korsgaard 1996). CEOs have described their 'mentor VC' as supportive and friendly (Fried & Hisrich, 1995). Literature widely considers mentoring to be a VC NFVA (see e.g. Fried & Hisrich, 1995; Gabrielsson & Huse, 2002; Gomez-Mejia, 1990; Macmillan, 1989; Sapienza, 1992). A respectful relationship not only gives the VC power, but also creates a dynamic where information flows easier and both parties attain more power (Gomez and Mejia, 1990). The mentoring role therefore has positive effects on other VC NFVA activities as well (Sapienza 1992; Busenitz et al. 2004).

4.1.6 Recruiting

'Rather an A-team with a B-idea than the other way around' is a common saying. The management team is central in the pre-investment evaluation phase for VCs (Tyebjee & Bruno 1984) and evidently just as important post-investment. Several scholars have found VCs to participate in recruiting activities and in particular to executive positions (Ehrlich 1994; Gorman & Sahlman 1989; Hellmann & Puri 2002; Timmons & Bygrave 1986).

In a study of venture-backed and non-venture-backed companies, Hellmann & Puri (2002) found that VCs play a significant role in bringing outsiders into the position of the CEO and also engages in the recruitment to other positions such as the VP of sales and marketing. The CEO is a central character in a firm and one that also the VC not surprisingly views as important. Supportive of this are the findings by Cumming & Johan (2008), which indicates that the VC is

30 percent more probable to allocate himself the right to replace the founding entrepreneur as CEO if the investment has a pre-planned trade sale exit strategy.

The engagement in recruiting activities suggest that the VC perceives the entrepreneurial team to lack the adequate skills required for the growth stage associated with the infusion of venture capital (Zider 1998) and 'fills the gaps' of the resource base by hiring capable professional management. Moreover, from the moment a team has filled all key positions, the VC are likely to be less involved in the activities of the portfolio company, and several scholars concur that VCs are more active in early phases of the portfolio company (Sapienza & Korsgaard 1996; Timmons & Bygrave 1986; Sapienza & Timmons 1989). E.g. upon hiring a CFO, the VC becomes less involved in financial matters (Gomez-Mejia 1990).

The task of recruiting new personnel might however have a negative impact on the relationship between the team of entrepreneurs and the VC since the entrepreneurs might think the activity is meddling (Busenitz et al. 2004). The recruitment issue therefore seems to be both an important and difficult activity for VCs.

5 The theoretical acquiring perspective

Our initial theoretical model is constructed by comparing the DD considerations of the acquirer with the VC NFVA activities found in the literature review. Overlapping areas indicate activities where the VC might add non-financial value in a trade sale context. Our findings are summarized in Table 2. This table is not exhaustive, and the authors have had some challenges defining the scope and borders of the DD subunits related to each other. The table does however indicate that some of the different activities performed by the VC may be ascribed importance from the acquirer's perspective. Some of the subunits are weakly linked with research on VC NFVA e.g. market DD, while others seem to be more influenced, for instance the financial and legal DD. The authors were not able to find any connection between the IT DD and VC NFVA, and this DD process has therefore been removed from the model, indicating that the authors do not believe that VCs can influence this DD process.

Due Diligence sub-analysis (Picot, 2002)

VC NFVA

	Strategic Decisions	Mentoring	Recruiting	Monitoring	Financial Advice
Financial and Legal Assure financial structure is sustainable (Howson 2003). Control and use of historical data and project future earnings. Accuracy in the numbers is critical (Harvey & Lusch 1995). Legal contracts are investigated for unexpected liabilities (Picot 2002).		Provides feedback if the reporting or performance is inferior with the VCs expectancy (Ehrlich 1994).	Participates in recruiting activities and in particular to executive positions(Timmons & Bygrave 1986; Gorman & Sahlman 1989; Ehrlich 1994; Hellmann & Puri 2002), e.g. the CFO.	Requires formal documentation like monthly financial reports from the entrepreneurial team to monitor progress (Gomez-Mejia 1990; Rosenstein et al. 1989), sets high performance and reporting standards for their investments (Ehrlich 1994; Rosenstein 1988).	Helps with financial management, structuring the financing of the firm and legal contracts (Gomez-Mejia 1990), assist in establishing internal managerial systems and control (Ehrlich 1994).
Market Evaluate relative market share and stability (Rao et al. 1991), future possibilities and risks and evaluate the applicability of target's historical data (Harvey & Lusch 1995). Uncover strategic fit (Howson 2003).	Central in making strategic decisions (MacMillan et al. 1989; Rosenstein 1988; Sapienza & Korsgaard 1996; Wijbenga et al. 2003), e.g. what markets to enter, product wrapping and mix, business model and strategic relationships.				

Table 2: Initial model based on literature review.

VC NFVA

Due Diligence sub-analysis (Picot, 2002)

	Strategic Decisions	Mentoring	Recruiting	Monitoring	Financial Advice
Human Relations Evaluate strengths and weaknesses of key employees (Harvey & Lusch 1995), fit in management style (Rao et al. 1991), organizational readiness and resistance (Hall 1993; Hall 1992), uncover human and social capital (Picot 2002). Management team resistance is a deal breaker (Picot 2002; Rao et al. 1991).		The mentoring role creates a good relationship where the VC can motivate the NVT for the trade sale through the "relationship power" (Fried & Hisrich 1995; MacMillan et al. 1989). Mentoring can also accelerate the NVTs learning (Busenitz et al. 2004; Fried & Hisrich 1995).	Participates in recruiting activities and in particular to executive positions (Timmons & Bygrave 1986; Gorman & Sahlman 1989; Ehrlich 1994; Hellmann & Puri 2002) and often uses their network to attract high caliber and experienced individuals. Preservation of the founding team increases chances of acquisition success (Gerasymenko & Arthurs 2010), the value inherent in start-ups is typically tied up in human capital (Gompers & Xuan 2009), e.g. entrepreneurial teams.		
Organizational Evaluate procedural and hierarchical efficiency (Picot 2002), decision making processes (Rosenbloom 2002), decision making and organizational culture, balance in organization and management of work processes (Harvey & Lusch 1995).		VCs can help develop systems for coordination, integration and differentiation (Gomez-Mejia 1990).	Participate in recruiting activities (Gomez-Mejia 1990; Sapienza & Korsgaard 1996; Timmons & Bygrave 1986; Sapienza & Timmons 1989) 'filling' gaps in the resource base e.g. by hiring a new CEO, CFO or VP of sales or marketing (Hellmann & Puri 2002).		

Table 2: (Continued)

6 Findings

The nine interviews shed some light on the DD processes of entrepreneurial companies, and offered new insights into the categories mentioned by Picot (2002). In general, the interviews indicate that DD practices used are based on theoretical principles, but each company seems to have some alterations of the DD process based on their own experience. However, the motivation for the DD is similar, and the results that the DD produces are found to be similar across the data sample.

The acquirers emphasized that the DD provides valuable insights to a trade sale. According to the acquirers, advisors are often used to assist in gathering all or part of the information used in the DD. The advisors interviewed in the study indicated that they always assisted in a financial DD, but also stated that they offered clients a more thorough analysis of the company through other DD subunits. One advisor validated the importance of the DD by saying that the information uncovered often causes the deal to not be consummated.

> Our task is to create a best possible foundation to make the decision, a lot of our deals ends up not being done (Puma - advisor).

6.1 Strategic motivation

Our interviews revealed that the acquirer put an emphasis on strategic value and industrial rationale when acquiring companies. From the acquirer's perspective, the strategic consideration involves finding a suitable place for the potential target company in the product portfolio or distribution channel. The acquiring company has a strategy guiding the company's operational direction, and this strategy also influence any potential acquisitions. A strategic compatibility seems to be the basic premise for even considering an acquisition.

> I can't remember buying a company without doing a strategic DD (Leopard - acquirer).

Our findings indicate that strategic considerations seem to take place prior to the acquisition process itself. The acquirers in our study indicated that acquisitions were initiated with a strategic DD; meaning a test of the strategic compatibility between the target company and the acquirer. The acquirers emphasized that entrepreneurial companies need to be visible for potential acquirers to become viable targets for the strategic DD.

> The first time we contacted the management was after we had verified that they could fill a hole in our strategy (Snow Leopard - acquirer).

6.2 Organization

Our interviews indicate that acquirers experience differences in the DD processes with regards to size and age of the target firm. Entrepreneurial companies do not have the same reporting standard as larger companies, and much of the knowledge seem to be tacitly dispersed among the entrepreneurs. Several of our interviewees touched upon this subject, and one of the advisors summed up the general mentality in our study through the following statement:

> DD on smaller companies are often complex due to the lack of documentation. Monthly financial reports, contracts, customer relations are examples. These companies are driven by sales or development, so they don't have the resources to establish documentation routines (Cheetah- advisor).

The interviewees seemed to accept the lack of documentation and chaotic condition as a necessary evil when acquiring entrepreneurial companies. From the acquirer's perspective the documentation can be put in place at a later stage, so despite the challenges connected to the chaotic organizational structure it is not deemed a deal breaker. The following statement made by one of the acquiring firms shows this:

> We often find large differences in the way a founder-driven company is run and the way we do it. I mean, when the entrepreneur is in the center of the company, know the industry in and out and has taken the company from its infancy to where it is now, many founders almost tend to run it on their gut feeling. They know what contracts they might get, at what price and terms, without having a lot of specific documentation. We are normally at an arms-length to the company, and thus we need to put in place reporting systems and professional management procedures to get the information we need to take proper business decisions. This is not only connected to ownership, but also because founder-owned companies we buy often have reached a stage where such a professionalization is necessary (Leopard- acquirer).

This seemingly chaotic condition was recognized by several of the interviewees, and one interviewee indicated how this might influence the DD process. The lack of organizational structure makes the entrepreneur more important for the acquiring companies. There is not the same level of knowledge dispersed in the organization as a whole; rather it is split between key people in the firm. From the acquirer's perspective the entrepreneur becomes more important under such conditions.

> Early phase companies don't have the same organizational structure, so a lot of the competence is placed in the knowledge of the entrepreneur (Jaguar-advisor).

6.3 Legal and Financial

Despite the chaotic surroundings, the interviews revealed that some acquirers stay rigorous when it comes to the legal DD process of entrepreneurial companies. It is important for them to investigate the validity of patents and copyright issues. In addition contracts with suppliers and customers are examined for potential liabilities for the future. In general, the acquirer's look to validate that the legal contracts and rights are aligned with what they view as the true value in the acquisition. The acquirer needs to be certain that the company's critical components will come along after the trade sale. Negative findings in the legal DD can have major implications for the transaction.

> Copyrights, patents and freedom to operate issues are potential deal breakers (Cheetah-advisor).

Further, the acquirers indicated that they always performed a financial DD, often using a specialized advisor. The financial DD was influenced by the chaotic organization and potential lack of documentation, but the financials still played an important role in the DD. Even though it isn't always possible, our findings indicate that the acquirer hopes to see fully audited financial statements similar to large firms. From the acquirer's perspective, having financial numbers pre-verified by external auditors seem to largely affect the reliability of the financial DD. In terms of valuation based on the financial DD, the acquiring firms talked about the use of multiples like EBITDA, and how these were used in the valuation. But they did emphasize that for entrepreneurial firms multiples do not paint the full picture.

Several of the acquirers mentioned that they often pay a strategic premium for entrepreneurial companies, which cannot be defended through the use of traditional valuation models. Rather than straightforward using the results from a financial DD to calculate a theoretical value, a strategic premium was justified through the use of a business case simulating the future after the acquisition. The numbers from the financial DD are a key element in creating the business case, even though they might be uncertain. The acquirers indicated that the use of business case to some extent was an artform rather than a science, admitting that it was a risky way of evaluating.

> To defend the price we had to make a business case with sufficient growth, and that was full of uncertainty (Snow Leopard- acquirer).

6.4 Market and the NVT

In addition to the numbers from the financial DD, the business case is dependent on numbers that can validate the projected growth. From the acquirer's perspective, the projected growth seem to be dependent on both external factors like market development and internal factors related to the assumptions made and by the management and the strategic position of the target company. The acquirer emphasized that the numbers found in a market-oriented DD needed to be coupled up with the business case, along with historical data on performance and key information

> Most importantly we had to know that the very optimistic picture of their business in the coming years was based on real assumptions (Mountain Lion- acquirer).

In such a market DD process, the NVT of the target company seem to be responsible for providing the acquirer with the numbers that support their worldview in terms of growth projections. Our Interviews revealed that the numbers presented to the acquirer are scrutinized, and the legitimacy of the numbers does not only seem to influence the models in the business case. The acquirers also indicated that an important part of validating the numbers was to get a sense of the management quality.

> If the numbers that the management present don`t seem realistic or have weak assumptions, you have to worry about the management (Mountain Lion- acquirer).

All our interviewees emphasized the importance of the NVT when acquiring entrepreneurial firms. Even though the acquisition is strategically grounded, the acquirers expressed that the team is vital to create value following the trade sale. The findings indicate that that both the quality of the management team and the motivation to continue working is important. Red flags concerning the NVT's quality or motivation might be a deal breaker for the acquirers when acquiring entrepreneurial companies. This has a large effect on the DD process, where the acquirers wish to meet as many people as possible in order to be assured that the acquisition is possible.

It is very important for us to meet the target company management, as early in the process as possible, whether it is a structured process through an investment bank or just us and the target company. The quality of the management team is extremely important, and it is important for us to be aligned with them in the view of the road ahead. (Leopard- acquirer).

Due diligence sub-unit of analysis

Acquirer informant	Financial	Legal	Market	HR	IT
Mountain Lion	Often times when you look at companies which are not venture-backed, but are organically grown, you find that they don't understand the value of fully audited financial reports.	I mean we had to know about some of the technology contracts and about the customer contracts.	Most importantly we had to know that the very optimistic picture of their business in the coming years was based on real assumptions.	If you're facing a hostile management that makes it that much more difficult	
Snow Leopard	We ran a series of financial due diligence that made us understand whether an acquisition was realistic or not, especially if our valuation of the company and their asking price was in the same ballpark.	One important element in the DD process was their contract with the supplier of some core components.	To defend the price we had to make a business case with sufficient growth, and that was full of uncertainty.	Resistance from the team can be a deal breaker	
Lion	You really need to be able to follow the logic behind the numbers, where do they come from?		The quality of the technology and what it brings to the product portfolio is always going to be the primary thing, when you are making an acquisition to build out the product portfolio.	Within a day after receiving the information memorandum, we had checked out all the managers on LinkedIn.	
Tiger	We always use an advisor for financial DD, and we might do some extra calculations on working capital.		A typical acquisition starts with our middle managers who have been in touch with a potential partner or is jealous of a competing technology.	In addition, we always try to map the future together with the target company. If we disagree, that is a deal breaker for us!	We don't worry that much about internal software, but we do want the companies to follow our standards
Leopard				We prefer to buy companies where we think the existing management team can deliver the results.	

Table 3: Summary of findings from interviews with acquirers. The organizational DD has been omitted since no data was found.

Due diligence sub-unit of analysis

M&A advisor informant

	Financial	Legal	Market	HR	Organizational	IT
Panther				It is shortsighted to cheer after you negotiated a cheap price and you really feel you "won" the negotiation. All you get is a gang of demoralized people not motivated to create value.	Startups are often chaotic since the founder might have a large ownership stake, but he might not be in the board, but he can be the CTO at the same time. So there is a question of who can affect who before making decisions.	
Jaguar				Normally, there are strictly strategic reasons for acquiring companies, but you shouldn't underestimate the effect of corporate culture.	An early phase company doesn't have the same organizational structure, so a lot of the competence is placed in the knowledge of the entrepreneur.	The question of IT is connected to how the company will be integrated.
Cheetah	DD on smaller companies are often complex due to the lack of documentation. Monthly financial reports, contracts, customer relations are examples.	Copyrights, patents and freedom to operate issues are potential deal breakers.		If the individuals don't want to come along that is also a deal breaker.		
Puma	DD on smaller companies are much more chaotic since their financial function is less robust.		Acquiring a growth oriented business means you have to validate the market premises. Size and margins are important.	The acquirers are concerned with the team, and they almost always handle that part themselves because they have a lot of contact with the team in the target company.	The DD can also entail operational DD, where the production systems and routines are evaluated.	On the IT side, a typical question is whether the reporting system and IT platform can be integrated with the acquiring company.

Table 4: Summary of findings from interviews with M&A advisors.

7 Discussion

Following, attention will be directed towards the research questions posted. First, the acquiring perspective on entrepreneurial companies will be refined based on our findings. Secondly, the authors combine this refined acquirer's perspective with existing research on VC NFVA and present an improved understanding on how VC can add non-financial value to their portfolio firm from the acquirer's perspective.

7.1 RQ1: Important elements (DD) process of a smaller company

Aligned with the research on M&A (Howson 2003; Picot 2002), our findings indicate that financial DD play a part in the acquisition of entrepreneurial companies. However, it might seem that the financial DD carries less importance in the DD associated with acquisitions of entrepreneurial firms compared with the emphasis put on it in large M&As. Since the financial DD aims at uncovering the financial past (Howson 2003) and project future growth and earnings (Harvey & Lusch 1995), while at the same time venture-firms often lack the longer operating history existent in more mature firms (Ragozzino & Reuer 2007), the financial DD is less feasible simply because the basis for producing such models is meager. Nonetheless, the financial DD is performed independent of the size of the firm, as indicated by each and all of the interviewees, and deemed important in the sense that the numbers that are possible for the target to produce should be accurate and concise. The financial DD on entrepreneurial companies also seems to be influenced by what our interviewees called a 'chaotic organization'. This caused the retrieval of necessary documentation, e.g. for the financial DD, to be more cumbersome. Our findings indicate that the acquirers does not deem documentation to be decision critical in a trade sale, with one interviewee stating that the lack of it simply is a necessary evil when acquiring small entrepreneurial firms. However, the risk associated with the deal will be greater with the lack of documentation, something that might affect the price (Perry & Herd 2004; Wall & Smith 1997).

The legal DD seem, according to our findings, to be important for the acquirer of entrepreneurial companies, and especially the transferability and replaceability of all contracts were scrutinized. This is not surprising, since changing suppliers and contracts might enable the acquirer to harvest synergies and economies of scale, something which is found to be important for acquirers (Sirower & O'Byrne 1998).

In the literature review, the market DD was deemed as very important since this is an area with a lot of uncertainty induced by external factors such as macro-economic events. The DD should investigate the target's market share and its stability (Rao et al. 1991) and evaluate the applicability of the target's historical data (Harvey & Lusch 1995).

Our findings indicate that when acquiring entrepreneurial companies, the numbers from the financial DD and the market DD forms the basis for a 'business case', where assumptions and projections of future growth are backed up. In general, the business case is vital for the acquirer to defend the valuation of the entrepreneurial company. Several informants pointed out that the market DD was mainly done in-house when acquiring entrepreneurial firms; they perceived themselves to have the best insights to the industry of which they do business in and could more easily align this with their internal strategic considerations. This indicates that acquisitions of entrepreneurial firms are primarily consummated when the target and acquirer share the same industry, supporting the findings of (Capron & Shen 2007). This leads to another important point, which emerged in the interview, namely that the acquiring perspective on entrepreneurial firms emphasized the strategic fit of the entrepreneurial firm. The acquirer seeks to fill any gaps in its resource base when acquiring an entrepreneurial firm (Gompers & Lerner 2001), e.g. due to its innovative technology. Based on our findings, the importance of such a strategic fit seem to be more important when acquiring entrepreneurial firms than larger firms. The reason for this might be that when acquiring larger firms, the scale of the operations makes it possible to harvest huge values by simply combining administrative tasks and supplier contracts, making the need for further strategic value less important.

The emphasis on such a strategic fit has changed the perception of the DD process on an entrepreneurial company. In the refined model in table 5, the market DD is replaced with a strategic DD. This change is done for two reasons, firstly because the investigations of the external market is made less important since the acquirers seem to operate within the same market and therefore have very good knowledge of the market prior to the acquisition. Secondly, a main motivation for the acquirers seems to be to uncover strategic fit, and the market DD is one small part of such investigations. The interviewed acquirers stressed that such a 'strategic DD' is performed before any other advances are made to potential target company, testing the fit of the target to the strategy and how any technology, resources or competences in possession of the target can complement the acquiring company's resource base. This indicates that if a target is not visible on 'the radar' it might miss out on an exit opportunity. The authors therefore introduce the strategic DD process as important when acquiring entrepreneurial firms, and this DD process aims to combine market knowledge, the target firm's strategy and the acquiring firm's strategy to find the strategic value of the target firm.

Further, our findings indicate that team is crucial in the acquisition of an entrepreneurial company, aligned with researchers from both the M&A perspective (Howson 2003; Picot 2002; Rao et al. 1991) and entrepreneurial research (Gerasymenko & Arthurs 2010; Gompers & Xuan 2009; Graebner & Eisenhardt 2004). The acquirers emphasized that the willingness to be acquired in the new venture team (NVT) was important, as well as the competences of the team. The willingness to be acquired seems to be linked directly with the buy decision, supporting the findings of Rao et al. (1991). Based on our findings and previous research, the authors argue that that the HR DD is important from the acquirer's perspective when acquiring entrepreneurial companies.

Our findings in connection with the NVT further indicate that the evaluation of the team is not an isolated DD process, but entrenched in all other DD processes as well. E.g. the reliability of the financial numbers does not only seem to affect the financial DD process, but it is a measure to check the quality of the NVT and management. Hence, it seems like the outcome of other DD processes will affect the HR DD as well. The acquiring company views the NVT as responsible for the results in all DD processes since the target company in many ways is an extension of the NVT. This interconnectedness of the DD processes is a major difference between the DD on an entrepreneurial company compared to a larger company. Despite the interconnectedness, the authors still consider the HR DD process as a stand-alone process as well. It should be kept as a stand-alone DD process because not every aspect of the HR DD is picked up by other DD processes. The motivation of the NVT to continue to work for the acquirer is a good example of a consideration which only a specific HR DD process seem to investigate.

The organizational DD did not seem to be important for the acquisition of entrepreneurial companies, despite the importance in larger acquisitions (Picot, 2002). The interviewees reasoned that the entrepreneurial organization is chaotic and the knowledge seems to be tacitly placed among entrepreneurs rather than in the organization, making it less important to get an overview of the balance in the organization. While the organizational DD becomes less critical, it increases the importance of the HR DD. In addition, our findings indicate that other elements of the organizational DD are moved to the legal DD. One advisor pointed out that a complicated ownership structure could present an organizational challenge, but this should be covered in part by the legal DD and HR DD. Aligned with our findings, we argue that since some elements of the organizational DD is dispersed to other DD processes. This makes the organizational DD less important when acquiring small companies. Unlike with the HR DD, our findings do not indicate any organizational DD elements that are not covered by the other DD processes. Hence, our refined model will not include the organizational DD as vital when looking at entrepreneurial companies. The lack of focus on organizational DD might be explained by the size difference of the target company and the acquirer, making the acquirer believe that organizational DD is not important based on the simpler organizational chart of the entrepreneurial firm.

The difference in size also comes to sight in the IT DD process. Aligned with our initial model, our findings indicate that this is somewhat neglected in acquisitions of smaller companies, despite the advantages of having such a process (Sarrazin & West 2011; Boomer 2011; Popovich 2001). The authors argue in a similar matter as with the organizational DD: it seems the size removes some of the potential adverse effects the integration of the target's IT system pose, and therefore this is not prioritized in a hectic DD process.

7.2 RQ2: Where can the VC add non-financial value from the acquiring perspective?

Our findings considerably altered our perception of the DD process when acquiring a, often small and young, venture-backed company. Based on our reflections on RQ1, we now bring the improved understanding of the DD together with the research on VC NFVA, to show where a VC might add non-financial value to a company in a trade sale exit context.

Even in small companies with uncertainty, the financial DD seem to be a focused on number crunching where balance sheets and profit and loss models are analyzed. Creating the 'spreadsheets' that is analyzed is a day-to-day activity, and more operational than what VCs prefer to be involved in. The persons responsible for these spreadsheets are the executive management, and particularly the CFO. The VC is found to be highly involved in the hiring of management (Timmons & Bygrave 1986; Gorman & Sahlman 1989; Ehrlich 1994). We argue that the VC might play an indirect role in affecting the financial DD, through hiring of a qualified CFO which can create value for the acquirer. Further, the lack of valid information was found to pose a challenge for the acquiring company in the financial DD. This offers a valuable perspective for the exit minded VC. Since this is a challenging area for the acquirer, the VC might create non-financial value through governance structures like formal monitoring, an important VC NFVA activity (Sahlman 1990). By having in place formal monitoring with reporting standards, the VC can create value from the acquirer's perspective by providing easier access to valid and required information in the DD process.

The legal DD is found to play an important part in the acquisition of smaller companies, and VCs also play a part in the design of legal contracts (Gomez-Mejia 1990; Sapienza 1992). The research does not provide evidence on how detailed the VCs are involved with the legal contracts, but the authors do find sufficient evidence from existing research to argue that VCs can create value from the acquirer's perspective through aid with legal contracts.

One of the biggest changes in our understanding of the DD process on entrepreneurial companies came within the field of strategic DD. Instead of having an external focus on the market outlook, the acquirers investigate the strategic possibilities of combining the two firms, and market outlook is a part of that. From the VC NFVA research, working as a sounding board for strategic decisions is found to be very important (MacMillan et al. 1989; Rosenstein et al. 1989; Sapienza & Korsgaard 1996; Wijbenga et al. 2003). The VC is found to contribute to firms within industries they are familiar with (Sapienza & Korsgaard 1996; Sætre 2003), and involvement in strategy development is not limited to board decisions, but also informal strategy sessions (Gomez-Mejia 1990). The prior research show that the strategic DD is highly influenced by the VC, and the authors argue that strategy involvement can create value from the perspective of the acquirer.

Aligned with our initial model, HR DD plays a vital role in the acquisition of entrepreneurial companies, both in terms of the quality of the team and the motivation of the team to join the acquiring firm. As we anticipated, there seems to be two areas where the VC can add value from the acquirer's perspective. The VC is a key decision maker in the recruitment process (Timmons & Bygrave 1986; Gorman & Sahlman 1989; Ehrlich 1994), and this indicates that recruitment of competent personnel can be of great value from the acquiring perspective. Another less obvious element of the HR DD process is the motivation and willingness of the NVT to be acquired. If the entrepreneur expresses unwillingness or a negative attitude towards the trade sale, the consequence is most certainly a negative outcome of the DD or the acquisition (Rao et al. 1991).

The VC is found to take a mentoring role towards the CEO (Busenitz et al. 2004; Sapienza 1992), creating a relationship where the VC provides the CEO with e.g. interpersonal advice in matters other than business related (Sapienza & Korsgaard 1996). Such a relationship can create a possibility for the VC to influence the mentality of the NVT towards a trade sale, and thereby creating value from the acquiring perspective.

7.3 The refined acquirer's perspective

Based on our findings and the discussion above, the authors put forth the refined model in Table 5. In this model, financial and legal DD are split up due to their distinct differences both in VC involvement and DD process. A strategic DD process is introduced, which is similar to the market DD in our initial model, but emphasizes the role of strategic fit over the external market conditions. The HR DD is found to be important for the acquirer, and is kept similar to the initial model. The acquirer's perspective downplays the importance of DD streams looking at the organization and the IT when acquiring entrepreneurial companies. Efforts by the VC within these areas are therefore not likely to create important value from the acquirer's perspective; hence these are removed from in the refined model.

The model further indicate links between what the acquirer looks for in a DD process, and VC NFVA activities previously found by scholars researching venture capital. E.g. are the VC and CEO found to disagree on the importance of the VC in strategy formulation (Gomez-Mejia 1990). The findings from this paper indicate that the VC's role in strategy formulation might play an important role, further validating that the inclusion of the acquirer's perspective in such regards contributes to the understanding of NFVA activities. From a theoretical perspective, the VC NFVA activities included in the refined model is indicated to specifically create value for an acquirer, and are thus more important compared to other NFVA activities. However, these value-adding activities extracted from previous research have been researched scholars who have not taken into account how the acquirer associates value with them. Accordingly, the links between the DD process and specific VC NFVA activities in the model should first and foremost be viewed as a theoretical verification that the acquirer's perspective adds nuance to existing research on VC NFVA. By employing the acquirer's perspective, some VC NFVA activities are deemed less important, e.g. the legitimation role of the VC. Hence, this refined model invites future researchers to investigate the suggested links between VC NFVA and DD processes, a topic that will be expanded in the next chapter.

DD process	***VC NFVA***
Financial	- Hiring of CFO (Ehrlich, 1994; Gorman and Sahlman, 1989; Hellmann & Puri, 2002; Timmons and Bygrave, 1986) - Formal monitoring (Sahlman, 1990)
Legal	- Advice on legal contracts (Gomez-Mejia, 190; Sapienza, 1992)
HR	- Recruitment (Timmons and Bygrave, 1986; Gorman and Sahlman, 1989; Ehrlich, 1994) - Mentoring (Sapienza, 1992; Busenitz et al., 2004)
Strategic	- Sounding board (McMillian et al., 1989; Rosenstein et al, 1989; Sapienza et al., 1996; Wijbenga et al., 2003) - Strategy sessions (Gomez-Meija, 1990)

Table 5: Refined model merging the proposed sub-units of analysis in a DD process of an entrepreneurial firm with VC NFVA activities extracted from previous research.

8 Conclusion and Implications

This paper set out to offer new perspectives on 'the black box of VC trade sale exit' by investigating how the VC can add non-financial value to their portfolio firms from the acquirer's perspective. Specifically, the paper sought answers to the following research questions:

> **RQ1**: How is the due diligence process on an entrepreneurial company?
> **RQ2**: Based on the acquirer's perspective reflected by the due diligence process on an entrepreneurial company: How can the VC create non-financial value in the portfolio firm?

The acquiring perspective of the trade sale is developed through a literature study of the DD conducted prior to the acquisition and nine interviews with seasoned acquirers and M&A advisors. To relate VC activities to value creation in a VC trade sale exit, the paper introduced a state of the art perspective on VC NFVA activities. For the first time to the authors' knowledge the VC NFVA has been evaluated by use of the acquirer's perspective.

We concur with most of the existing research on VC NFVA, and agree that the VC adds value to the portfolio firm beyond financial investment. Specifically, our findings indicate that formal monitoring of the portfolio firm, recruitment, mentoring, aid with legal contracts and involvement in strategic decisions creates value from the acquirer's perspective. These activities positively influence the DD process that the acquirer runs prior to the acquisition. Positively influencing the DD process increases the VCs chance for a successful trade sale exit (Wall & Smith 1997).

8.1 Implications for practitioners

This study has touched on an increasingly important area for VCs, how to succeed with the trade sale exit. The general advice to VCs is that they should keep exit vehicle in mind at all times, since our findings indicate that NFVA activities do change with the choice of exit vehicle. The paper has proposed a set of specific VC activities, which is indicated to create value for the acquirer in a trade sale exit. We recommend practitioners to include these activities in their work with portfolio companies, and especially emphasize the VC's role in pointing out the strategic direction as important. Companies seem to be visible and attractive due to their strategic position, so the VC should keep the trade sale exit in mind when coming up with the strategy for the portfolio company. Examples of strategic choices might be which partners to choose and what products to focus on. It seems like acquirers have a roadmap of the future, indicating what products and distribution channels they will focus on. To increase the chance at selling the company, it is important for VCs to develop a company that fit into such a roadmap. We therefore argue that the VC should gain insight into the 'future roadmap' of potential acquirers, although this can be challenging since it involves gaining access to the strategy of potential acquirers which might not be publically available. VCs should however refrain from limiting his focus to one potential acquirer; since the acquirer might reconsider its roadmap and leave the venture-backed company in no man's land in terms of strategic fit.

The acquiring perspective viewed the acquisition of entrepreneurial companies as complicated due to the lack of information. Even though the acquirers accepted such conditions as a necessary evil because of the entrepreneurial nature in terms of both employees and the structure, this finding emphasize that having a certain structure can add value in a trade sale. Especially the NVT should take notice of this, and should not view the time spent on documentation as a waste, even though it does not create value in the short term, e.g. is not directly linked to the next sale.

8.2 Implications for further research

This paper has offered a state of the art perspective on VC NFVA activities and shed some light on the acquisition of an entrepreneurial company. The paper operates in the cross section of two separate strands of research, and has therefore pushed the frontier within two research fields.

From an M&A perspective, this paper contributes by shedding light on the how the DD process is conducted when entrepreneurial companies are acquired compared to the process when larger companies is acquired. The study has been highly exploratory, and future research should continue to shed light on the acquiring perspective through more elaborate studies on the considerations made when acquiring venture-backed companies. Especially interesting for further research is the indication of the overarching role of the HR DD. How does the other DD process influence the HR DD process? How do other DD processes influence each other? These are interesting questions future research should try to answer.

The authors are surprised of the findings related to the seemingly unimportant IT DD process. Researchers conclude that this area has huge effect on potential synergy realization (Boomer 2011; Sarrazin & West 2011), although one might argue that the IT-related synergy potential is smaller for entrepreneurial firms. However, our findings indicated that most of the acquirers had no particular reflections on the IT DD, which the authors suspect to be due to the technical complexity of an IT DD. The persons responsible for transactions, on both sell and buy side are often business-educated, and therefore finances and strategies is closer to their heart. Future research should look more thoroughly into how the IT influences an acquisition, and interesting question is whether this can be related to the technical expertise of the M&A team?

The contribution to research on venture capital is primarily ascribed to the state of the art perspective on VC NFVA, and secondly it sheds light on the trade sale exit. E.g. are the VC and CEO found to disagree on the importance of the VC in strategy formulation (Gomez-Mejia 1990). The findings from this paper indicate that the VC's role in strategy formulation might play an important role, further validating that the inclusion of the acquirer's perspective in such regards contributes to the understanding of NFVA activities. A limitation of the study is that it simply uses theoretical findings to conclude where the VC might add value. From a venture capital researcher's perspective, several interesting questions emerge related to our finding that some VC NFVA activities seem to create value from acquirer's perspective while others do not. First of all, does the VC keep the trade sale exit in mind when choosing which activities to perform? How conscious are the VCs on what activities can lead to value from the acquiring perspective? Future researchers should do empirical investigations where the acquirer's perspective is included to build on our preliminary findings, with the aim of confirming or disconfirming whether and how VC NFVA activities previously found by scholars add value from the acquirer's perspective or not. E.g. does the financial DD seem important; what is the VCs role in preparing the portfolio firm for such an event? Previous research indicates that VC contribute in the recruiting of executive personnel, can this contribute in preparing the firm? Further, the HR DD is also deemed important. Can the VC-NVT relationship be a factor contributing to the willingness of the entrepreneurial team to join the acquiring company post-deal? A research design that includes the acquirer's perspective on these issues will create a more nuanced picture of how and whether a VC can add value, and is likely to produce results that have implications for both researchers and practitioners.

Future research should also broaden the acquiring perspective to look beyond the DD process, and try to get a better overview of the acquisition process from start to finish. Our findings indicate that strategic considerations are important for an acquisition, and an interesting field for further research is how these transactions are initiated. Is the DD process a valid proxy for the acquiring perspective, or should other aspects of the trade sale be included? How do investment banks and advisors on both side of the table influence the trade sale?

From an academic perspective, the acquisition process of venture-backed companies is a grey cloud full of uncertainty, and investigations into this area might provide valuable insights for research on VC NFVA. In 2006, the US had 10 500, acquisitions, but only 386 of these were venture backed, so the authors recommend that the research on the acquirer's perspective should be initiated by venture capital researchers. M&A researchers are not likely to pick up this field of research, since it is very narrow in its scope.

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Paper 2

The Acquirer's Perspective on the Venture Capitalist's Role in Motivating the New Venture Team for a Trade Sale Exit

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Abstract

Research on venture capital has by large concluded that VCs add non-financial value to their portfolio companies through a variety of activities. Many view the efforts made to aid the top management through recruiting, motivating and mentoring as a critical VC non-financial value adding (NFVA) activity. Research on entrepreneurship supports this by stating that the entrepreneurial team is crucial for the success of the venture. A recent string of entrepreneurial research has investigated the new venture team (NVT) in light of exit, and the research indicates that the capabilities needed differ with the choice of exit vehicle.

From a venture capitalist's (VC) perspective the IPO is often viewed as a home run in terms of exit vehicle, but truth is that trade sales make up the vast amount of return for most VCs. The market for IPOs is tougher than ever, and the importance of successfully selling portfolio companies privately is increasing. From the perspective of the NVT, a trade sale might present a challenging situation since they can be ousted from the company after handing over the ownership to the acquiring company. For this reason, this paper aims to investigate how VCs planning to exit through a trade sale let this strategic choice affect the activities related to the top management team, and how these activities add value in the trade sale. More specifically, the authors develop a theoretical model for how the VC can affect the extrinsic (financial) and intrinsic motivation of the NVT, and how this will be related to value creation from the acquirer's perspective. An exploratory research design, where the VC, the entrepreneur and the acquirer in three Norwegian VC-backed trade sales are interviewed, will refine this model. For the first time, to the authors' knowledge, the acquiring company is included to create a state of art perspective on the VC's value-adding role in venture-backed companies exited through a trade sale.

The willingness of the team to be acquired is shown to be crucial for trade sale success. Two distinct factors of motivation for the NVT were identified. The VC plays a major role in contributing to the extrinsic (financial) motivation of the entrepreneur through the use of value-based compensation structures. Our most important finding is that it seems to be crucial that the VC does not overlook the intrinsic motivation of the NVT since this is a key element for the success in a trade sale exit. This discovery adds a perspective to the traditional view that a VC can align the NVT's interest with sufficient financial incentives. In order to succeed with influencing the intrinsic motivation of the NVT, it is important that the VC keeps a good

relationship with the NVT. A good VC-NVT relationship enables the VC to influence the NVTs motivation through three specific activities: (1) facilitating meetings between the NVT and acquirer, (2) mentoring and (3) communication of intended exit strategy.

1 Introduction

A VC's ultimate goal in any investment is a successful exit, harvesting a handsome return to their limited partners and themselves. The most common exit routes are by an initial public offering (IPO) or through a trade sale. Trade sales are a primary exit for venture capital, and have become more prevalent under the current market conditions (Gompers & Xuan, 2009). Currently, trade sales have gained little attention from academics, partly due to the iron curtain of information associated with private acquisitions. With the relative increase in trade sales and current gap of research, this paper set out to add perspectives to some of the constructs within the "black box of trade sales." Acquisitions are a critical feature of venture capital activity that warrants deeper study and exploration (Gompers & Xuan, 2009). The paper will investigate how a trade sale exit strategy affects the VCs non-financial value-adding (VC NFVA) activities.

A challenging and critical aspect of research on VC value adding activities in a trade sale context is the question on how to measure the "value added" of a specific VC activity. A trade sale is a transaction between the previous owners and the new owners, and in the end the acquiring company will decide how to value the target company, and therefore what return the shareholders of the venture-backed company can achieve. The information on the valuation is often confidential, and even if the numbers were freely available, it is not easy to link value creation to a specific VC activity without including the acquirer's perspective on the matter. The authors therefore argue that the acquiring company needs to be a vital part of the research on VC NFVA. By adding the acquirer's perspective, the specific VC activities can be rated by the true judge of the "value added" by the VC.

Earlier research on VC NFVA has concluded that there are several areas where the VC can add value to their portfolio companies (De Clercq, Fried, Lethonen, & Sapienza, 2006; Ehrlich, 1994; Large & Muegge, 2008; MacMillan, Kulow, & Khoylian, 1989; Tyebjee & Bruno, 1984). One interesting string of research has started to look at the importance of founding team, and Gerasymenko & Arthurs (2010) concluded that the preservation of the founding team seems to be more important in a trade sale than in an IPO.

The research on mergers and acquisition (M&A) supports this finding. The knowledge within the entrepreneurial team is a prime example of a capability that can create sustained competitive advantage for the acquirer (Gerasymenko & Arthurs, 2010; Ranft & Lord, 2002). The acquisition of new capabilities through the purchase of small, venture capital-backed start-ups is a strategy that has been employed by many large technology firms including Facebook, Zynga, Google, Cisco and Apple. The value inherent in these startups is often intangibles assets, such as the entrepreneurial teams' human capital and perceived growth opportunities (Gompers & Xuan, 2009; Ragozzino & Reuer, 2007). An intangible asset like human capital and managerial quality is hard to grasp for an acquirer and will therefore be subject to substantial investigation prior to the acquisition (Graebner & Eisenhardt, 2004; Picot, 2002; Rao, Mahajan, & Varaiya, 1991). The acquirer will therefore add a substantial amount of value to the NVT and this indicates that the VC should focus some of their efforts on the NVT to succeed with a trade sale.

Looking at the VC-NVT dyad, one particular observation from existing research offers interesting insights into where the VC should focus his efforts. From the entrepreneurial perspective, a trade sale exit strategy seem to present conflicting interests between the VC and the NVT. Several researchers have focused their efforts on understanding the underlying motivation of entrepreneurs (DeTienne & Chandler, 2010; Shane, Locke, & Collins, 2003; Wennberg, Wiklund, DeTienne, & Cardon, 2010), and there is a paradox concerning the goal alignment of the VC and the NVT in a trade sale. A successful exit and financial gain is the foundation of the VC business model, but the NVT might have motives that are independent of capital gain (Carter, Gartner, Shaver, & Gatewood, 2003; Shane et al., 2003; Shane & Venkataraman, 2000; Taylor, 1999; Wiklund, Davidsson, & Delmar, 2003). This conflict is also indicated through the observations of Cumming & Johan (2008), who found that companies with a preplanned trade sale exit strategy have a 5% bigger chance of replacing founder CEOs.

This paper will investigate how the VC work with the NVT to overcome any conflicting motives to exit the portfolio company, and whether or not the acquirer value these efforts by the VC. The authors develop a theoretical model linking VC NFVA activities and the importance of the NVT for the acquiring company. Based on this theoretical model, five research questions are derived.

1. How do the acquirer value the NVT in a trade sale?
2. To what extent does active information gathering through a close relationship between the NVT and the VC, like for instance trough a mentoring role, create value from the acquirer's perspective?
3. How can specific information to the NVT about the intended exit strategy create value from the acquirer's perspective?

4. How does a connection between the NVT and the acquiring company create value from the acquirer's perspective?
5. How do compensations schemes based on exit create value from the acquirer's perspective?

In order to answer these theoretically founded research questions and refine our initial model, the authors have conducted an inductive multiple-case study of three trade sales made by Norwegian VCs. The VC, the CEO and the acquirer has been interviewed to create a state of the art research design making this paper the first to our knowledge to use the one true judge of VC NFVA in a trade sale context. This leapfrog of existing research designs creates methodological challenges, but also creates a brand new perspective on the trade sale of VC backed companies.

This paper is organized as follows. First the methodology is described to give the reader an insight into the state of the art research design. The reader is then given a frame of reference to gain an insight into how M&A theory views the importance of the NVT and its motivation. In the following chapter the authors introduce the theoretical framework with an initial exploratory model and the research questions it is founded upon. The findings of our inductive case study will be presented, and on the basis of the findings the research questions will be discussed and the model will be improved. In conclusion, the authors present the implications for practitioners and further research.

2 Methodology

The research design is a multiple-case, inductive study involving the trade sale of 3 venture-backed firms. Multiple cases enable replication logic where each case is treated as an experiment, allowing for confirmation or disconfirmation of inferences drawn from the others (Yin, 2008). The case study research design is likely to have strengths like novelty, testability and empirical validity and is particularly well-suited to new research areas for which existing literature seem inadequate (Eisenhardt, 1989), which is well aligned with this exploratory study. The research also uses an embedded design that includes the VC, CEO and a representative from the acquirer as the units of analysis. Although more complex, the upside of the embedded design is that it permits induction of richer, more reliable models (Yin, 2009). Since this study pioneers the inclusion of the acquirer's perspective in research on VC NFVA activities, we elaborate on the methodology used so that future researchers seeking to endeavor on the same path may take advantage of our experience.

2.1 Research setting and motivation

We chose the NVTs motivation as a research setting due to the high importance acquirers put on it (Angwin, 2001; Picot, 2002). In addition it seems that literature on venture capital point to conflicting goals between the NVT and the VC in a trade sale exit (Busenitz, Fiet, & Moesel, 2004; Cumming & Johan, 2008). We were therefore motivated to explore the existence of a link between the considerations made by the acquirer on the NVT and the NFVA activities a VC contributes with as an active investor. We chose to investigate this premise by also including the acquirer's perspective, build on the rational that it may paint a more transparent picture of what VC NFVA activities contributes with in regard to the human resource (HR) due diligence (DD), and was also largely motivated by the fact that previous research in general is limited to exploring VC NFVA activities from the perspective of the entrepreneur, the VC or the dyad between them (Ehrlich, 1994). In addition, trade sales as a whole has gained little attention from academics in the venture capital scene. This is mainly attributed to the limited publicly available data in private acquisitions (Schwienbacher, 2005) in contrast to that of IPOs. This gap in current research and the importance of filling it is further enhanced by the predominance of trade sales as the primary exit vehicle for VCFs (Ernst & Young, 2011; Gompers & Xuan, 2009; NVCA, 2012).

2.2 Sampling

Given the research questions presented, we sampled Norwegian venture-backed firms that had undergone an industrial trade sale. After gaining access to a list of acquisitions, we shortlisted it to 6 potential cases based on the exit event's nearness in time. The reason for this was two-folded. Firstly, the likelihood that the informants accurately remembers the events are higher the less distant in time (Huber & Power, 1985). Secondly, we expected it to be more likely to gain access to the person responsible for the acquisition at the acquiring company (PRAAC) the closer the acquisition date. The rationale was that organizational changes might come about over time in the acquiring company, i.e. employee turnover and career advancements. It proved difficult to get the attention of the PRAACs, primarily due to the unavailability of the person in question who often had executive positions in large offshore corporate companies, and the secrecy they put on such strategic issues. Since it was a prerequisite that we gained access to the PRAAC for the cases to be eligible, the list was further reduced to three cases shown in table 1. One of the cases included is distant in time, contrary to our selection criteria. However, being endorsed with the collaboration of the PRAAC proved so difficult, that we needed to lighten on the time constraint. The hardship in producing eligible cases including the collaboration of all of the three parties may be ascribed to the reason why such a study has not been conducted before.

Case	***VC***	***Target company***	***Acquirer***
Thor	Lead investor	CEO	Managing Director
Odin	Lead investor	Founder CEO	VP Corporate Dev.
Frigg	Lead investor	CEO	Head of SBU

Table 1: Overview of interviewees

2.3 Data sources

The study is based on several data sources: (1) qualitative data from semi-structured interviews with the VC, CEO of the acquired company and a PRAAC. (2) emails and phone calls to follow up interviews and (3) archival data, including company websites and press clippings.

Due to the small sample of cases, we started with interviewing informants not connected to the cases who had considerable knowledge on acquisitions both on the buy-side and the sell-side and both of non-venture-backed and venture-backed firms. The interviews varied from 30 to 40 minutes and included one entrepreneur, two venture capital firms, three advisory firms, one private equity fund and an interview with a private Norwegian company that recently acquired several non-venture-backed companies. The interviews followed a more open-ended format, with questions that were often idiosyncratic to the expertise of the informant. The interviews were formative in gaining an understanding of the acquisition and sales process in general and of venture-backed firms in specific, while also serving as a proxy to the triad between an entrepreneurial firm, the VC and the acquirer. The interviews were transcribed verbatim, totaling 53 single-spaced pages, coded and grouped in categories based on Picot's (2002) overview of the five sub-analysis that a DD should include. This assisted us in developing relevant lines of questions for the three distinct interview guides used during our main interviews and provided some conceptual clarification for the research questions.

The following two months, we conducted nine interviews with our key informants and 6 follow up interviews, varying in length from 30 to 60 minutes. All but one interview was tape-recorded; in the one that was not, the informant exercised his right not to be recorded, and notes were taken instead. All the other interviews were transcribed verbatim, totaling 66 single spaced pages.

Our initial entry was made through the VC, who then identified and referenced the individuals relevant at the acquirer and the target company. By including all three parties involved in the trade sales we obtained the story from all the relevant perspectives of the trade sale, which helps mitigate subject biases in the accounts narrated (Golden, 1992; Miller, Cardinal, & Glick, 1997) and helps build a richer and more elaborate model of processes and events (Schwenk, 1985; Yin, 2009). Also, such highly influential and knowledgeable informants are the most reliable and are particularly so when recalling recent important events (Huber & Power, 1985; Kumar, Stern, & Anderson, 1993). Considering that the VC and the CEO on the sell-side was generally more available, we interviewed them first before turning to the PRAAC. The logic is that the PRAACs are probable not to have in-depth knowledge of the events leading up to the trade sale, an insight that served an important foundation in constructing a "mental storyboard" of how the entrepreneurial firms developed from an early stage to the exit event. Along with the acquiring companies websites and press clippings, the "mental storyboard" was helpful in gaining a better understanding of the acquirers motivation to acquire the firm so that the time available for the interview could be utilized effectively in uncovering relevant constructs and relationships with regard to the VC's NFVA activities.

Throughout our data collection, we took steps to minimize informant biases. The interviews with the VCs and the venture-backed firms began with them giving a description of accounts leading up to the exit process. When seeking retrospective reports, such an open-ended question primes the interviewee to recount details from the specific case, rather than general notions, and should lead to higher accuracy in our data when we asked more specificity demanding question (Lipton, 1977; Miller et al., 1997). In addition, we emphasized the importance of focusing on facts and events, rather than on respondents' interpretations, especially of each other's actions (Eisenhardt, 1989). Acquisitions and trade sales are a delicate matter to the parties involved, especially the acquirer. Consequently, to motivate our informants not to hold back on information, we promised confidentiality (Huber & Power, 1985; Miller et al., 1997; Yin, 2009)

2.4 Data analysis

After completing the initial interviews with all the informants, we analyzed the data by first extracting quotes, coding them with keywords and further tabulating the three perspectives within case. This enabled us to perform "triangulation" between the interviews of the triad and was a central aspect in our case writing, outputting rich and more reliable accounts of the processes during and pre-exit (Jick, 1979). A core aspect of the inductive process was that we allowed constructs to emerge from the data, rather than being guided by specific hypothesis. Although we early on noticed similarities and differences between the cases, we strived to not perform any analysis cross-case, in an effort to maintain the independence of the replication logic.

Following the within-case analysis of the embedded units, we utilized the standard cross-case analysis technique (Eisenhardt, 1989), looking for similarities and differences between the cases. Through replication logic, we developed initial propositions on the relationships between VC NFVA activities and value of the NVT in the eyes of the acquirer. We often revisited the data, and as constructs, causal relationships and tentative propositions emerged, we found the need to follow up the initial interviews with interviews of the informants from the venture capital firms and the CEOs of the acquired company. Since the study is exploratory in its form, the follow-up interviews helped us to perform a "sanity check" of the developed tentative model and accompanying argumentation. It also verified that we had understood the accounts given correctly and we received further comments on accountants relevant to the model that was not fully covered during the more open-ended initial interviews. This ensured a closer relationship with the exploratory models developed in the discussion and the world as perceived of the practitioners.

2.5 Limitations

This study is based on a sampling of three completed Norwegian trade sale exits. As such, the results are not statistically significant. Due to the geographically small focus and lack of cases across several industries, the external validity of the study may be argued to be less and thus regarded to not be generalizable to the general population of venture-backed trade sales. Although we took steps to minimize informant bias, we cannot be sure that we were fed subject portrayals of accounts and events that may have affected our data

3 Frame of reference

In order to have a theoretical backdrop on the investigation of how VC involvement can create value in a trade sale through motivation of the organization, the following section will look deeper into the literature of why acquirers purchase entrepreneurial companies, entrepreneurial motivation and how these to aspects influence the acquisition process. Based on this theoretical investigation, the authors put forth a model based on research questions investigating how the VC can add value to the portfolio company in a trade sale context.

3.1 Acquirers motivation

M&A researchers have been drawn to the vast amount of value at stake when two large corporations enter a merger or acquisition. The acquisitions of smaller target companies are therefore not a much-researched topic. But despite of this, acquisitions of smaller companies are important for larger organizations. As larger firms often struggle innovating their resource base due to path dependency caused by self-reinforcing mechanisms (Sydow, Schreyögg, & Koch, 2009), they may try to reinforce their resource base through acquisition of smaller companies with a specific technology. This can be exemplified by looking at Intel in the year 2000, where they spent twice as much on acquisition of new technology and markets as they spent on R&D (Eklund, 2000). No matter how innovation-driven organizations are today, they need outside assistance with innovation (Rigby & Zook, 2002).

Organizational integration is the most important activity in order to achieve synergy realization (Larsson & Finkelstein, 1999), and thereby value creation for the acquirer. There are two opposite strategies of handling this issue, where one involves keeping autonomy and the other aims to achieve total integration of the acquired firm. However, no matter which of these is chosen, researchers conclude that the NVT is important for acquisition success; either due to their deep understanding of the acquired company's technology and market position (Winter, 1987) when they are integrated, or because of the possibility to re-combine their knowledge into new innovations (Kogut & Zander, 1996) when they are left as separate business units. In knowledge-intensive and innovation-driven industries, the most sought after strategic resource are highly skilled human capital (Ranft & Lord, 2000). Hambrick & Cannella (1993) supports the importance of the team by concluding that executives from acquired firms are a vital part of the resource base, and hence they are also valuable in the acquisition (Granstrand & Sjölander, 1990;

Walsh & Ellwood, 1991). If the acquired firm's top managers were to leave after the acquisition, this will affect the post-merger phase negatively (Hambrick & Cannella, 1993). The NVT is not only important due to their knowledge and competence, but they are also important as examples for others in the acquisition process. If the entrepreneur stops acting as a driving force of the organization, it might lead to a negative performance effect (Ooghe, Laere, & Langhe, 2006).

The M&A research points to the importance of the NVT in a trade sale of a venture-backed company. By looking at research focused on entrepreneurs and venture capital, a conflict of interest between the VC and the entrepreneur appears. Even though extrinsic (financial) motivation plays an important role in the life of many entrepreneurs, entrepreneurs have a variety of non-financial reasons for starting their own firms (Wiklund et al., 2003), including self-realization, autonomy and a desire to exploit a perceived opportunity (Carter et al., 2003; Shane et al., 2003; Shane & Venkataraman, 2000; Taylor, 1999). Since a trade sale often involves giving up power to a larger company and stepping down from executive positions (Black & Gilson, 1998), many entrepreneurs prefer IPO as an exit to a trade sale (Schwienbacher, 2008). This paradox have some empirical evidence from the field of VC research; since the entrepreneur has intrinsic reasons for resisting an acquisition, preplanned trade sale exit are associated with stronger control rights and veto rights by the investor (Busenitz et al., 2004). In addition, when looking at companies with preplanned trade sale exits, the chance of replacement of a founder CEO increases with 5 % (Cumming & Johan, 2008).

Because of the importance of the team in a trade sale, the acquirer's DD prior to the acquisition will include a look at the NVT and whether the key team members will oppose the acquisition or not (Picot, 2002), and this is even found to be a deal breaker given all other factors are positive (Rao et al., 1991). From the VC's perspective, the NVT will consequently be important for achieving a trade sale exit. An important task for the VC is therefore to ensure the key members of the NVT are not negative towards a trade sale or a potential acquirer.

4 Theoretical Framework

Financial and personal motivations are not mutually exclusive, and the most entrepreneurs have a combination of the two (Wright & Robbie, 1997). VCs with a successful trade sale exit record have been able to both motivate and incentivize the NVT to get their goals aligned (Wall & Smith, 1997). Figure 1 depicts an exploratory model explaining how VCs can add value in the eyes of the acquirer through their work with the NVT and the incentive systems they create.

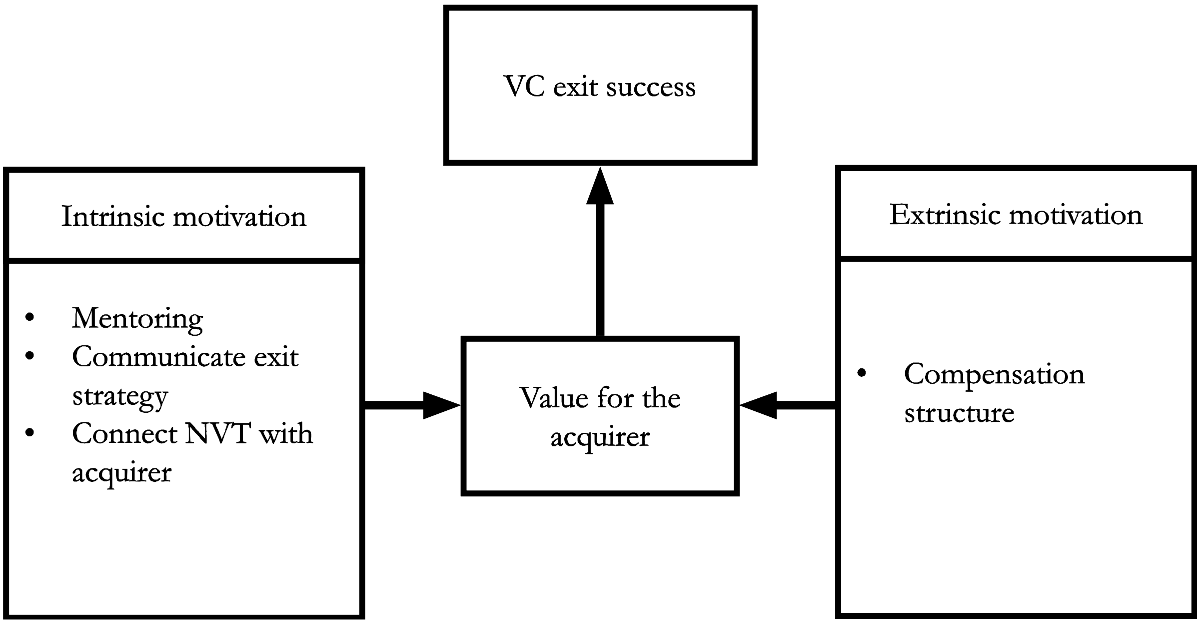

Figure 1: Initial theoretical model

The interaction between the VC and the entrepreneur is made up of a variety of the formal mechanisms in the boardroom (Gabrielsson & Huse, 2002; Rosenstein, 1988), and in less formal channels like phone calls and meeting (Gomez-Mejia, 1990). This makes the relationship between the entrepreneurs and the VC very complex from a theoretical perspective (Sapienza, Korsgaard, Goulet, & Hoggendam, 2000). In order to fully understand how the VC can motivate and align his and the NVT's interest, the authors use prior research on VC NFVA combined with the theoretical lenses of both agency theory and procedural fairness. The following chapter will be used to develop the rationale behind the model and it will present the research questions that make up this model.

4.1 The importance of the team

The M&A literature is mainly focused on larger companies and transactions, and this causes some problems for the exit minded venture capital researcher. The authors of this paper have used the knowledge-based view (KBV) of the firm, as an argument for why the VC activities related to NVT motivation is important for the acquirer. KBV has its origin in studies of larger firms, so the authors argue that even this basic assumption of transferability should be investigated in order to validate the importance of this study and to give the exploratory model better foundation. It is important for the model to validate that the team is important in the acquisition of smaller venture backed companies as well. The first research question the authors set forth is the following, and is a basic premise for the entire model.

RQ1: How do the acquirer value the NVT in a trade sale?

4.2 NVTs intrinsic motivation

Researchers have concluded that non-financial (intrinsic) motivation is important for entrepreneurs (Carter et al., 2003; Shane et al., 2003; Shane & Venkataraman, 2000; Taylor, 1999; Wiklund et al., 2003). The intrinsic motivation of entrepreneurs creates a problem for the VC in a trade sale context (Schwienbacher, 2008; Wall & Smith, 1997). NVTs with high level of intrinsic motivation are likely to resist a trade sale that involves giving up control of the company (DeTienne & Chandler, 2010). Since negativity from the NVT will cause problems for the acquirer, the question for the exit-minded VC becomes how to combat the NVT's intrinsic reasons for resisting a trade sale.

Procedural justice theory is well suited to understand the decision process in a group where one party doesn't have direct control over the decision (Sapienza & Korsgaard, 1996), a situation similar to the one between the NVT and the VC (Gorman & Sahlman, 1989). The psychology literature shows that when participants can't directly control the decision being made, they care more about the decision process (Korsgaard, Schweiger, & Sapienza, 1995; Leung & Li, 1990). In a VC-NVT context, this means that the NVT will use the decision process to reflect upon the strategic decision made by the board (Kim & Mauborgne, 1993), e.g. the decision to exit through a trade sale. Procedural justice theory therefore give valuable insights into how the VC can behave in the decision process to signal fairness to the NVT, and thereby increasing the acceptance of the exit decision.

Two aspects have been found important in order to create the perception of fairness in decision-making processes, namely voice and consideration (Korsgaard et al., 1995). Voice is defined as the possibility the affected parties have to present relevant information in the process and consideration is the extent of which the given input is considered and understood (Leung & Li, 1990).

Giving the NVT a voice can be done through informal meetings from early on. Several researchers suggests that the VC's role as a mentor is an important NFVA activity, where the VC and the top management (CEO) can talk about a wide array of topics not limited to business strategy (Fried & Hisrich, 1995; Gabrielsson & Huse, 2002; Gomez-Mejia, 1990; MacMillan et al., 1989; Sapienza, 1992). From a procedural justice perspective this is a good arena to get the CEO or others in top management to reveal all relevant information and opinions concerning the trade sale. This informal relationship and information channel will allow the CEO to talk about his intrinsic motivation and other thoughts he might have about a trade sale exit. Since this possibility to present all the information is likely to have a positive effect on the perceived fairness in an exit decision, the authors set forth the following research questions:

RQ2: To what extent does active information gathering through a close relationship between the NVT and the VC, like for instance trough a mentoring role, create value from the acquirer's perspective?

4.3 Communication of intended exit strategy

Explanation and expectation clarity are two important management principles for succeeding with procedural justice (Kim & Mauborgne, 2002). By transferring this logic to the VC-NVT relationship, the authors argue that the VC should clearly communicate the exit intention as early as possible. Through early and direct communication the VC can be certain that the NVT understands the ramification of the exit strategy, enabling the VC to start a dialogue with the NVT on how to succeed with the exit strategy. The importance of goal congruence to the success of a venture has been widely acknowledged (Parhankangas, Landström, & Smith, 2005; Shane & Cable, 1997; Zacharakis & Shepherd, 2001). Early communication can either ensure goal alignment, or it can reveal resistance. By creating such a dialogue early on, the VC creates a situation where the NVT can feel that they are a part of the exit process. The earlier the NVT is informed, the better, since this is a very effective way of creating a fair decision process, which maximizes the possibility that the NVT is satisfied even though they initially resist a trade sale. This makes the authors ask the following research question:

RQ3: How can specific information to the NVT about the intended exit strategy create value from the acquirer's perspective?

4.4 Connecting management and acquirer

The same management principles, explanation and expectation clarity (Kim & Mauborgne, 2002), might shed some light on the NVTs resistance against a trade sale. From the research on venture capital and entrepreneurship, the resistance is based on the fear changes can bring about in the entrepreneurial culture and power structure (Chandler & DeTienne, 2010; Schwienbacher, 2008, Wall & Smith, 1997). The general mentality of NVT seems to be that the acquirer will incorporate the smaller company and removes their autonomy (Busenitz et al., 2004, Black & Gilson, 1998). By looking at the M&A literature, this perception is however refuted. The modern acquiring firm is faced with a dilemma of integrating or letting them stay separate (Haspeslagh & Jemison, 1991; Puranam & Srikkanth, 2007). Findings in research on integration policies indicate a clear need to avoid a simple one-stage integration of acquired firms (Schweizer, 2005). The integration process has been the foci of many researchers, and several of critical aspects have been identified (Ranft & Lord, 2002). However, negotiators often overlook detailed discussion concerning the integration phase since it is complex and other topics seem to be more pressing (Haspeslagh & Jemison, 1991). This lack of focus on the integration in the negotiation phase seem logical, considering that the VC's prime interest is getting the highest possible return on his investment.

Not having the integration phase in mind is however problematic for two reasons. First, for the acquirer, it complicates the integration phase where the synergies are supposed to realize the value inherent in the deal (Haspeslagh & Jemison, 1991; Larsson & Finkelstein, 1999). Secondly, and more importantly from the VC's perspective, the management team might grow uncertain on how their future looks like, and this can make it more likely that they will resist the exit decision. It therefore seems that it will be in both the NVTs and the VCs best interest to minimize the uncertainty concerning the future of the target company. Involving the NVT in the acquisition process, and making the integration plan a topic for discussion between the management of the acquiring firm and the NVT of the target company can do this. It has been shown that managerial efforts in the M&A process are positively related to the end result (Teerikangas & Very, 2006). Therefore the authors set forth the following research question:

RQ4: How does a connection between the NVT and the acquiring company create value from the acquirer's perspective?

4.5 NVTs extrinsic motivation

Research on NVTs and entrepreneurship indicates that one important motivation for starting new business is extrinsic (Certo, Covin, Daily, & Dalton, 2001; Wennberg et al., 2010), including wealth acquisition, personal income generation or an increased possibility to add income (Kuratko, Hornsby, & Naffziger, 1997). Some even suggest it is the defining objective for the entrepreneurial process (Certo et al., 2001). In a trade sale context, this extrinsic motivation will ensure that the NVT will be interested in a highest possible deal size, since this probably leads to the highest possible financial gain for the NVT as well.

The VC operates a business where he or she is dependent on delivering sufficiently successful rates of return to the limited partners in order to get access to new capital (Tyebjee & Bruno, 1984). The interest of the VC and the NVT is seemingly well aligned, however the picture is a bit more complicated than that. The relationship between the NVT and the VC is a prime example of principal agency theory (Sahlman, 1990; Sapienza & Korsgaard, 1996), where it is difficult to for the principal (the VC) to control that the agent (the NVT) acts properly (Eisenhardt, 1989). Formal monitoring becomes crucial for VCs to combat the lack of information (Sahlman, 1990; Shane & Cable, 2002).

The VCs have become experienced in handling these uncertainties through contracts (Sahlman, 1990) specifying (1) staging of capital infusion, (2) compensation systems directly linked to value creation and (3) distribution of any financial return. Through the structuring of financial contracts, the VC hopes to align the extrinsic interests of the NVT and the VC (Kaplan & Strömberg, 2001), and at the same time minimize information asymmetry (Wijbenga, Postma, Van Witteloostuijn, & Zwart, 2003). An important mechanism to align the personal motivation of the entrepreneur for a trade sale is use of compensation through stock options (Kaplan & Strömberg, 2001; Sahlman, 1990), which can only be realized through exit. Due to the importance of the team in an acquisition and the VC's role in giving the NVT a financial incentive the authors to put forth the following research question

RQ5: How do compensations schemes based on exit create value from the acquirer's perspective?

5 Presentation of the cases

Serving as an introduction to the findings presented in the next chapter, we provide the reader with a short introduction to the three cases.

Case	*Industry*	*Investment duration [years]*	*Deal size [MNOK]*	*Acquirer revenue [MNOK]*
Thor	Hardware & Software	3	14	~ 1000
Odin	Software	10	Undisclosed	~ 605
Frigg	High-tech	6	900	~ 6000

Table 2: Overview of cases

The Thor-case was an early investment made by the VC due to his belief in a growing market. The company developed a combination of software and hardware and the Thor-VC exited in three years. With a deal size of only 14MNOK, the Thor-VC agreed that the return was not magnificent, but he deemed it as an ok investment, and a good exit compared to what they came to expect. The acquiring company was a large company with about one bn NOK in revenue, and the acquisition was also very successful from the acquirer's perspective.

Odin was a long investment for the VC; it took 10 years to exit the business. The company survived several macroeconomic crises, but the market distress largely influencing the projected growth plan. There were several owners, but the VC was the chairman of the board and lead investor. The deal size remains undisclosed, but with the acquiring company having only 605 MNOK in revenue, the deal size is most likely in a range that deems the exit as only moderately successful. Much of the compensation was based on performance following the acquisition.

The Frigg-case was a large investment, and later stage than Thor. The company had a high tech product, and they needed substantial funding to scale the business. The Frigg-VC exited the company six years later and harvested a very generous return, making the exit very successful from the Frigg-VCs perspective. The large acquiring company, with revenue of six billion NOK felt they had to dig very deep in their pockets to acquire the company.

6 Findings

6.1 Thor

The acquisition in Thor was a strategically motivated acquisition, where the acquirer was looking for a quick entry into a new market. However, in the following statement, it is shown that the acquirer still emphasizes the importance of the team.

> The true value for us was the market position. They suited our new strategy very well, but in order to further develop that market position, we knew the team would play a vital role. (…) We had a strategy vision, and the acquired team was critical to reach our goals. (…) Resistance from the team can be a deal breaker, since we wanted to keep the team and get them to perform for us as well (Thor acquirer).

The CEO in Thor was brought in after the initial investment of the VC, but the initial founding team continued to operate within the company. The new CEO had some new perspectives on how to grow the company, and also said he was well aware of the consequences of working in a venture-backed company in terms of future prospects.

> If you receive venture capital, it is pretty much in the cards that the company is going to get sold at some point in the future, and then you as an entrepreneur and owner have to be motivated to join in on that (Thor CEO).

The VC and the CEO seem to have had a good relationship, where the main focus was always the development of the company. The CEO did not feel that strategic decisions were made between the two of them, but in a more open process in the board of directors.

> Our decisions were made in the board of directors. Sometimes the management presented ideas or problems, and other members would respond. We were all reasonable people, so we managed to figure out a road ahead together (Thor CEO).

The VC invested in a very early stage, and to minimize their risk, the VC had negotiated several clauses in the term sheet. Specifically the liquidation preference became important in the exit phase. The VC had overestimated the multiples in the sector where the company operated, so they found it unlikely that the exit would create the value they had anticipated. Upon this discovery, on the VCs own initiative, the term sheet was renegotiated, and the liquidation preference was altered.

> In order to achieve exit we found it necessary to give up our liquidation preferences so that the other owners could gain a sufficient return. We did this to motivate all employees for a trade sale, even at a lower valuation. Having major discussions among the equity holders could upset a buyer like [the buying company] (Thor VC).

From the NVTs perspective, this action was important for the trade sale. The CEO made it clear to the authors that without the removal of the liquidation preference; the trade sale would have collapsed. But the acquirer also had to motivate the NVT prior to the deal consumption. The NVT were given the opportunity to see what the acquirer had to offer, and this contact became crucial for the success of the trade sale exit as well. The CEO recalls

> The financial incentive was not good enough to motivate us for the deal. There had to be something else there to motivate. Our perception of [the acquirer] did change in a slightly more positive way during our contact prior to the acquisition. It made us confident that the company was a match, and we were truly keen on using our technology platform in a completely different solution. So the non-financial motivation balanced out the lack of financial motivation. This worked, since most of the people are still there (Thor CEO).

The acquirer felt the team was very effective and professional in the acquisition process. They willingly gave any information, and did not signal any negativity towards the acquirer. At the same time as the VC went to great lengths to secure a financial motivation for the NVT, the acquirer offered another perspective of the financial motives of the NVT

> We were conscious of the financial motivation of the NVT, and since they have a vested interest in selling they might put on a show to reach the highest possible price. But we found no such indications (Thor acquirer).

6.2 Odin

This acquisition was a technology acquisition from the acquiring perspective, but they still did not try to hide that the team was important for the acquirer. The CEO confirmed this and felt he was a crucial part of the acquisition. The VC more than shared this attitude. The company had been through several rough periods, surviving multiple macroeconomic crises. At certain points the position of the CEO was debated in the board of directors, and the VC commenting on the importance of the team told us the following:

> The company didn't have a lot of proprietary technology; so the team, and especially the founding entrepreneur was very important in the acquisition. (…) I held a hand over the CEO. I was confident that to harvest value from [the company], he was the best bet (Odin VC).

The acquirer agreed with the importance of the team, and specified that it was not all about the knowledge and competences of the team, but they focused on a social aspect as well. The management team needs to fit into the culture, and the acquirer stated that it is a potential deal breaker

> If you don't like the people, you never actually make the deal happen. The type of company that we are, we are not so hung up on technology that if we loved the technology but hated the people, we still wouldn't do the deal (Odin acquirer).

The VC and the CEO had a prior connection, and also kept a tight relationship throughout the investment period. The CEO had a goal to run a world leading company, but when the circumstances began to show great challenges, the relationship with the VC was actively used to talk about exit possibilities. Both of them pointed to these talks as important means to shape the CEOs attitude toward a trade sale exit. The VC said:

> Me and the entrepreneur have openly discussed most things, and have a very good connection. (…) The entrepreneur had ambitions to become larger than we became, and the exit decision was partly made because of gentle nudges in that direction by me (Odin VC).

Following the decision to exit via a trade sale, the NVT as a whole were given a fairly lucrative financial incentive program, where they were given a bonus over a certain deal size in addition to the payout due to their equity. The acquirer saw the need to change the payment structure last minute due to external market conditions, and from their experience this caused some disruption among the NVT. The acquirer did largely rely on an earn out model and a retention bonus to ensure that the team would stay for as long as possible. Both the acquirer and the CEO viewed the financial motivation as only part of the transaction. In order to create an interest to stay on board after the trade sale, other than financial incentives, the NVT were offered high-ranking positions after the trade sale. The acquirer wanted to be sure that the NVT could see a professional future in the new company.

> And then the final thing really is the career development and reputational part which is not so obvious, but what it really is about. A lot of these guys had probably gotten as high as they could in the smaller business. Now there is the opportunity to those who buy into it; to be part of something bigger. And that was what we tried to sell to them as a vision when we met them. So, we're trying to be the one European company that takes on all the Americans, there's a chance of more global mobility, chance of bigger jobs (Odin acquirer).

From the acquirer's perspective, the decision to acquire this company came after a long and time-consuming process. There had been some communication about a possible partnership between the two companies some time prior to the acquisition, but this had not ended in anything, and ended up affecting the acquirer in a negative way. The acquirer elaborated:

> The team had previously engaged in talks considering an alliance with us, got engaged with us, but suddenly they disappeared and went off and signed an agreement with one of our competitors without really communicating that well to us. It didn't leave a very good feeling in our house. (…) It is like they went out with someone else and it didn't go very well, so now you're coming back for another date with us (Odin acquirer).

Prior to the acquisition, the acquirer did an analysis of the organization and the people within. They wanted to make sure that the entire organization was ready to be acquired, and that any prior knowledge of the firm would cause a problem.

> So we're always doing the DD of the higher level; do we like the CFO, the CEO, all those people, the CTO. What does a good exit look like? What does an acquisition event look like? All of those type of questions. So you get the executive level view. They're really telling you the story you want to hear, so that's why we went one level below and talked to a lot more of the people, about what they genuinely thought. How they felt about the [the acquiring company] brands, about what type of business we were and what we uncovered was mostly kind of positive feelings especially on the cultural level. They were all happy to be acquired by a European company that was successful and growing. (…) So I think they ended up with a pretty positive view among their management team, which you can have seen so far, because none of them has left (Odin acquirer).

6.3 Frigg

The acquisition in Frigg was also strategically motivated, but the team is still mentioned as important in the trade sale. The acquirer recalled:

> We were looking for a channel to launch our new strategy, but just as important was the competences and skills that the team brought with them. (…) we felt really strongly that we wanted to keep the NVT in place (Frigg acquirer).

The company had been through a management buy out prior to the investment, so all the executives had been given stock option agreements, and even after the investment the employees held close to 50% of the stocks. This meant that a trade sale would mean a substantial payout to the founding executives, and this caused some issues from the acquirer's perspective. The acquirer commented:

> We had a management incentive program. In this case it was difficult (to motivate the NVT) because they got all their money up front, and each of them got quite a lot of money (Frigg acquirer).

The VC- NVT relationship was mainly focused around the VCs role as chairman of the board, and neither felt the VC acted as a mentor in any way. Regarding the trade sale exit, the CEO and the NVT always wanted to keep the door open for an IPO, but from the VCs perspective this was never a plausible exit. Even though there was a conflict of interest regarding the exit decision, the decision process was evaluated as fair by the CEO, who stated the following:

> The management team wanted to keep the door open for an IPO, but the VC believed in a trade sale exit. The decision process was fair enough, and we ended up choosing a structured sale. The idea was to keep the door open, but after hiring the financial broker, the IPO never really became a serious alternative (Frigg CEO).

The VC started talking to other companies in connected industries 1-2 years after investment, and from the VCs perspective, the NVT seems to have been very involved in the decision process. The VC said:

> We had some situations where we could merge with other companies. Then the NVT got to discuss whether the merger had an operational logic, this was to ensure that the decision wasn't some random thought from the stockholders (Frigg VC).

A financial broker was used to organize the selling process, which to a large extent separates this exit process from the two others in our study. All communication was directed through the broker, and they organized a total of 4 rounds of management presentations for the winning bidder, in addition to phone calls and more informal meetings. The role of the VC became pretty insignificant in the exit process since the broker handled most of it, but from the acquiring perspective the VC did play a part. The relationship between the VC and the NVT created value in the acquisition. The acquirer told us:

> One of the true values of the VC was that he had the trust of the founding executives, which is not always the case. He was close enough that we were certain it was going to be a collaborative take over instead of a hostile acquisition (Frigg acquirer).

It turned out to be a collaborative take over, where the management team preferred the buyer throughout the process, and decided to not accept the highest bid in the end. The CEO said:

> The management team knew of both acquisition candidates, and always had a preferred buyer. This idea was reinforced by the management presentations. We felt they were the right buyer based on strategic considerations and based on the future of our employees. (…) The management had up to 50% ownership, and so even when we could have sold to a different acquirer for a bigger lump of money, we chose this buyer based on the industrial rationale (Frigg CEO).

Our interviews indicate that the two other parts in the transactions viewed the team's willingness to be acquired as slightly different. Both the acquirer and the VC perceived the management team as not having a preferred buyer, and even slightly skeptical. The acquirer felt he had succeeded in convincing the management team that [the buyer] was the right place for them. The acquirer said:

> At first I think they were neutral because they didn't know what we were going to do with them, and they were concerned with being a smallish self-contained entrepreneurial company buried in a bigger and more bureaucratic company. Our intention was pretty much to leave them alone; you know to allow them to operate sort of as they had. At least my perception is that they began to feel a preference for [the buying company] (Frigg acquirer).

7 Discussion

We will now turn our heads to the exploratory model presented, and the research questions we posted to investigate the validity of the exploratory model.

7.1 RQ1: The importance of the team

As we expected to find, in all the case studies, the three parties agreed that the NVT was crucial for the attractiveness of the target company, and hence a very important factor in the acquisition. The results show that the team of a venture-backed company is vital in a trade sale, which follows the findings of Zingales (2000). In two of our case studies, the acquiring company stated that a strategic advantage was the prime reason for acquiring the company, but still the acquirer made it clear that in order to create value after the trade sale, the NVT was needed. Our findings support the knowledge-based view of the firm, where the team itself is a critical resource (Granstrand & Sjölander, 1990; Ranft & Lord, 2000; Walsh & Ellwood, 1991). Our findings are also aligned with the findings of Rao et al. (1991), which show that the team is a potential deal breaker. The acquirers stated that the team is evaluated as a decision-critical aspect, where valuation is an example of another such decision-critical aspect. Based on the alignment of our findings and existing research, we argue that the basic premise and scope for our exploratory model investigating value adding within NVT motivation is validated.

None of the NVTs in our study were openly negative towards the acquiring company or the trade sale, but two of them started out with the hope of continuing to lead their companies. A variety of reasons were given as to why they changed their mind, and at least some of this was attributed the VC and the financial incentives. Wright & Robbie (1997) also emphasize the different motivations for entrepreneurs. Prior research and the variety of factors influencing the NVTs mindset concerning the trade sale in our study indicate that the basic structure of the model, with an intrinsic and extrinsic route to persuasion for the VC is plausible.

7.2 RQ2: Mentoring

We argued that the mentoring role of a VC would increase the VC knowledge concerning a potential NVT resistance against a trade sale. The mentoring role was indeed used as a tool to shape the mentality of the NVT in the Odin case, which supports the findings of renowned researchers within the VC NFVA field (Fried & Hisrich, 1995; Gabrielsson & Huse, 2002;

Gomez-Mejia, 1990; MacMillan et al., 1989; Sapienza, 1992). The Odin-VC was aware of the conflicts of interest between the NVT and the VC, and did to some extent leverage his relationship to alter the mind of the Odin-CEO.

The similar conflicting goals are found in Frigg, but the mentoring role did not play a part in convincing the NVT. The situation was solved through open discussions in the board, and an explanation for this might be the equity share of the Frigg-NVT (close to 50%). With such representation of owners in the NVT, the communication in the board is likely to be dispersed easily among the NVT, and this might mitigate the need for a close mentoring relationship between the Frigg-VC and the Frigg-NVT. The CEO and VC in Odin also had a prior relationship, making it easier to create a mentoring relationship for the VC. A prior relationship with the VC increases the chance of investment for the entrepreneur (Shane & Cable, 2002), and this trust might therefore work both ways. The VC entrusts the entrepreneur with the money at the time of investment, and given the prior relationship, the entrepreneur trusts the judgments and thoughts of the VC during the investment period, allowing him to assume a mentoring role.

Even though the mentoring role was absent, the relationship between the NVT and VC convinced the acquirer in the Frigg case that the acquisition would be collaborative, and that confidence had an impact on the success of the trade sale. The original argumentation of the value added through the mentoring role was that the VC could use social capital in order to hinder negativity in the acquisition process. It was not anticipated that the acquirer valued the relationship itself. This discovery adds some nuance to where the value is created for the acquirer. From the acquirer's perspective, a good VC-NVT relationship has value in itself, while the mentoring role might create value through influence on the mentality of the NVT. Based on these findings the authors argue that keeping a good VC-NVT relationship should be included as a value adding activity in our model. Based on the findings concerning the mentoring role and the vast amounts of previous VC NFVA research that points to mentoring as a VC NFVA activity (Fried & Hisrich, 1995; Gabrielsson & Huse, 2002; Gomez-Mejia, 1990; MacMillan et al., 1989; Sapienza, 1992), the authors argue that the mentoring role of the VC should also continue to be listed as a value adding activity in our model.

7.3 RQ3: Communication of intended exit strategy

The VCs in our study had very different attitudes towards the communication of intended exit strategy. Interestingly, we found a connection between the mentoring role of the VC and the communication of exit strategy. The VCs in our study seems to employ one of these two strategies to communicate the exit strategy. We do not suggest that these two strategies of influence are mutually exclusive, but we do emphasize that there seem to be similar results in terms of the change in NVT motivation for a trade sale. Thor and Odin had VCs that openly stated that an industrial exit was the target, and the Thor-NVT accepted this without hesitation. The mentality of the Thor-CEO might not be surprising since he was hired by the Thor-VC, and knew very well what he got into when the VC hired him.

As mentioned, the Frigg-VC managed to avoid any resistance to the trade sale by using what the Frigg-NVT described as a fair decision process. It therefore seems as communication of exit strategy to the NVT builds up under procedural justice, where the NVTs attitude towards the exit strategy can be positively affected by explanation and expectation (Kim & Mauborgne, 1993). This is aligned with our argumentation on how the communication of intended exit strategy creates value from the acquirer's perspective, and this indicates that such communication is a VC value adding activity. Based on these observations, and the strong foundation of procedural justice, the authors suggest that communication of intended exit strategy deserves a place in our model.

7.4 RQ4: Connection between NVT and acquirer

The strongest signs of causality between VC-activity and change in the intrinsic motivation of the NVT can be found in the communication between the NVT and the acquirer. In two of the cases, all six perspectives agreed that more or less formal meetings between the NVT and the acquirers were very important to persuade the NVT that the buyer had good intentions, and this also made the acquirer certain that the team they acquired was as good as they thought. Some might argue that management presentations are a natural part of any trade sale, and therefore the value created shouldn’t be accredited to the VC. This concern has some validity, since the acquirer’s might demand a series of meetings with the team. However our study indicates that there are more meetings than the management presentation, and the effect such meetings have on NVT motivation seems to increase when the meetings are less formal. We believe the reason for this effect can be explained by the shortcoming in the NVTs knowledge about differences between large corporations and entrepreneurial firms. Entrepreneurial teams may have a skewed impression of what a trade sale really involves. Existing knowledge and research on M&A is based on larger mergers or acquisitions, but some researchers have indicated that other mechanisms are at play in the acquisition of a small company (Kitching, 1967). Based on the lack of information on how acquiring companies actually plan to integrate smaller companies, it is understandable that the NVT is skeptical to be acquired by anyone. However, acquisition of smaller and less known private firms are often motivated by a desire to maximize value for shareholders rather than the private benefits of managers (Draper & Paudyal, 2006). This indicates that an industrial rationale is behind the acquisition, and being presented with such an industrial rational is likely to have an effect on the intrinsic motivation of the NVT because they are interested in the future of the company. We therefore argue that our research show that setting up meetings between the acquirer and the NVT enables the two parties to communicate and find some common ground to remove uncertainty and skepticism on both sides of the table. Based on this, the VC role in facilitating such a communication is viewed as a value adding activity in our exploratory model.

7.5 RQ5: Compensation schemes

Not surprisingly, we found very strong indications that a compensation model based on exit value has an effect on the team motivation. From the extensive research on both entrepreneurs and venture capital, it seems beyond doubt that financial motivation will play a role for the NVTs motivation (Parhankangas et al., 2005). The withdrawal of the liquidation rights in the Thor case proved to be vital for the Thor-NVTs attitude towards the trade sale. Such a measure might seem drastically, and a sign that the exit was deemed to be a failure, but withdrawal of the liquidation preference is found to be a viable action within the research on contractual renegotiation, where researchers find that investors sometimes have to give up part of their cash flow rights to achieve support for an action favored by the investor, like a trade sale (Aghion & Bolton, 1992; Broughman & Fried, 2010).

An interesting observation was however our finding that indicated that too much of a payout might be viewed as negative from the acquirer's perspective. It seems as the acquirers also like to use a value based compensation model, and a newly rich entrepreneur might be difficult to motivate by pure financial incentives. This concern is supported by research on serial entrepreneurs, where financial motivation drastically changes following a payout (Wright & Robbie, 1997). Financial motivation seems to lie close to the heart of the VC- NVT covenant (Eisenhardt, 1989), and we do not argue that venture capital should alter its compensation models, but the evidence from our study do emphasize the importance of seeing the intrinsic motivation of the NVT in connection with the financial. It seems like the VC should be very careful about only focusing on the extrinsic motivation to motivate the NVT, since the intrinsic motivation to a large extent overshadowed the extrinsic motivation in two of the acquisitions (Thor and Frigg). Such a balance also finds a theoretical foundation since extensive use of contracts are likely to affect the relationship between the VC and the NVT (Busenitz et al., 2004; Sahlman, 1990; Ven, 1984), and procedural justice theory has shown that the relationship and the decision process between the VC and the NVT is vital for succeeding with motivating the NVT for a trade sale.

Based on our findings concerning the duality of the compensation schemes and the literature supporting it, we alter the exploratory model to also indicate that the VC needs to have a broad perspective, viewing their contractual rights and the extrinsic motivation as connected to the intrinsic motivation of the NVT. We suggest that the VC need to show procedural justice in decision processes revolved around contractual rights, and this might place them in a better position to shape the mentality of the NVT.

8 Improved model

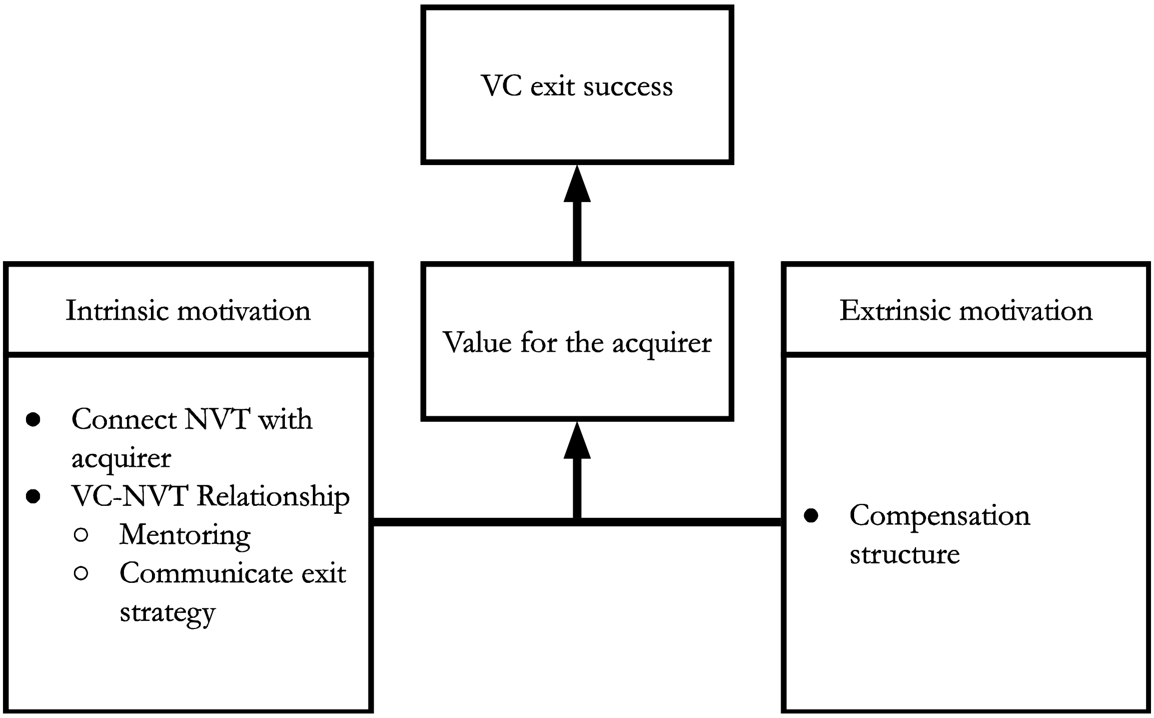

Figure 2: Improved model

Our findings have shown that the NVT is important in a VC trade sale exit, and the VC might harvest positive effects by motivating the team for a trade sale by extrinsic motivation or intrinsic motivation. Our initial exploratory model has been somewhat altered based on our findings, where the most important change is the relationship between the value the VC can create through intrinsic motivation and extrinsic motivation. The VC needs to focus on both motivational factors in order to create value for the acquirer through a motivated NVT. Our conclusions indicate that both of them play a role for the NVT and the acquirer, which again shows that it is important for the VC to put some effort into finding the right balance between the extrinsic and the intrinsic motivation of the NVT.

Our findings indicate that the value adding activities that were theorized did indeed create value for the acquirer, but there were some alterations from what we anticipated. When investigating the mentoring role, the VC-NVT relationship in itself also seems to be important in trade sales. Even though the VC-NVT relationship is not an isolated VC activity, we argue that it deserves a place in our model.

As mentioned, the strongest indication of a causal link to improvement of NVTs intrinsic attitude was found in the facilitation of meetings between the NVT and the acquirer. Hence, this activity is simply moved to the top of our list to indicate a relative importance. The data set in this study has some variations, so the authors argue that a deeper investigation and discussion concerning the ranking of the activities can be considered to be stretch the usage of a limited data set.

As we discussed in the previous section, our findings indicate that mentoring and communication of intended exit strategy are two basic strategies of influencing a NVT's motivation. The foundation for success in both of these strategies seem to be mutual, a good VC-NVT relationship. The improved model therefore depicts these strategies as being dependent on a good VC-NVT relationship, and at the same time the model indicates that a good VC-NVT relationship creates value in itself from the acquirer's perspective.

9 Conclusions and Implications

This paper set out to explore the VC NFVA activities related to motivating the entrepreneurial team for a trade sale exit. By combining the theoretical strings of VC NFVA, agency theory and procedural justice, the authors developed an exploratory model of how VCs might create value for the acquirer by motivating the NVT. A state of the art methodology was used to evaluate the activities performed by the VC in three case studies. For the first time, to the authors knowledge, the acquirer's perspective was used as a means to evaluate the "value added" by the VC in their portfolio company.

Two distinct factors of motivation for the NVT were identified. Firstly, the VC plays a major role in contributing to the extrinsic (financial) motivation of the entrepreneur through the creation of value based compensation structures. Secondly, our most important finding is that it seems to be crucial that the VC does not overlook the intrinsic motivation of the NVT, since this is a key element for the success in a trade sale exit. This discovery adds a perspective to the traditional view that a VC can align the NVT's interest with sufficient financial incentives.

In order to succeed with influencing the intrinsic motivation of the NVT, it is important that the VC focus on keeping a good relationship with the NVT. A good VC-NVT relationship enables the VC to influence the NVT's motivation through three specific activities: (1) facilitating meetings between the NVT and acquirer, (2) mentoring and (3) communication of intended exit strategy.

9.1 Implications for practitioners

The VCs do often view screening, growth and exit of portfolio companies as their main business areas. The authors argue that this paper has shown that the exit process is not something that follows screening and growth in a sequence, but rather need to be kept in mind in the entire lifetime of a VC investment. Not only on a strategic level, but also in activities related to motivating the NVT. Based on this exploratory study the authors feel the need to strongly encourage the VCs to consider the intrinsic motivation of the NVT as equally important as the extrinsic motivation. The financial motivation can be secured early through financial incentives in the term sheet, but this is not sufficient to secure goal alignment for a trade sale exit. Seemingly simple steps can ensure that the minds of the NVT are positive to a strategic trade sale, some of which are highlighted as VC NFVA activities in the model presented. The efficiency of each activity is most likely subject to variations between cases, but in general the relationship with the NVT should be as good as possible throughout the investment period. From the authors' perspective, no trade sale will be successful before the NVT reaches a minimum of both motivational factors, meaning that a large financial incentive will not suffice to secure the goal alignment. Such a mentality might even be harmful, because the acquirers often use financial incentives to motivate the NVT to join in after the trade sale. The VC should therefore continuously focus on the intrinsic motivation of the NVT, and this effort is likely to payoff through a successful trade sale.

When time arrives for the exit process, the authors encourage the VC to include the NVT in the exit process as much as they can, but retain responsibility in the price negotiations. The acquirers do not acquire the investor, but they acquire the NVT, and by making the NVT visible the VC is likely to create value for the acquirer, the NVT and the VC himself. The VC should however be responsible for negotiating the price for two main reasons. Price negotiation is a tug of war, and it is in everyone's best interest that the NVT-Acquirer relationship is kept intact for the post-acquisition process. Secondly, the acquirer's paint a bright picture of the future for the NVT, and the intrinsic motivation of the trade sale might therefore overshadow their financial motivation, making them ill equipped for leading price negotiations with the acquirer.

9.2 Implications for further research

The authors appraise the primary implication to future research to be the relevance of including the acquirer when researching whether VCs add value to their portfolio firms or not, and what these activities are. This cross section between acquisition theory and venture capital theory is a big black box, and with the declining returns of the venture capital industry and the increasing importance of the trade sale for VCs, this black box needs to be opened.

The authors have taken important steps towards opening the black box, and the refined model introduces four specific activities where VCs might add value of their portfolio firms from the acquirer's perspective. Future research should use this exploratory study to continue the research on these specific activities and do quantitative analysis on their relation to both intrinsic and extrinsic motivation of the entrepreneurs. Due to the limitations of the data sample, the authors did not put forth testable propositions, but still the refined model should be used as a starting point for other researchers. Based on our model, we believe that questions related to how intrinsic motivation potentially overshadows extrinsic motivation in an NVT should be followed up on. Such considerations might be of high value for VC practitioners and for entrepreneurs. The use of agency theory to enlighten the VC-NVT relationship does not seem to provide the full picture. The agency theory is evolved around handling asymmetric information and risk by imposing contractual arrangements (Eisenhardt, 1989), but our findings show that even though VCs impose strict contractual rights, they do not always exercise these rights, a finding supported by Parhankangas et al. (2005). Future researchers should try to elaborate the considerations a VC should do before choosing to emphasize extrinsic motivation, intrinsic motivation or both of them. Such explorations require insights in procedural justice, agency theory and VC NFVA, but can have practical implications for practitioners and help a troubling industry.

Even though this study has its origin in the research on venture capital, it has also contributed to a field of study the M&A researchers seemed to have ignored. The findings seem to indicate the team to be even more important in the acquisition of a small company than a larger organization. The authors argue that the acquisition of smaller companies deserves more attention from researchers from the M&A branch, and the authors believe this is a prerequisite for evolving the research on VC NFVA. However, in 2006, the US had 10 500 mergers or acquisitions where 386 of them were venture backed. From our perspective, trade sale exit minded VC-researchers should not count on much assistance from the M&A research field when it comes to the acquiring perspective. We therefore recommend that venture capital researchers elaborate this research field on their own initiative.

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Paper 3

Preparing For The Financial Due Diligence: the Venture Capitalist's Role in Professionalizing the Startup

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Abstract

This paper investigates how a venture capitalist (VC) contributes in professionalizing the portfolio company with regard to formal control systems and routines and how this affects the outcome of the financial due diligence (DD), and ultimately the risk the acquirer associates with the acquisition. A multiple-case study of three Norwegian venture-backed trade sales has been conducted to shed light on these relationships. The cases included the lead VC, the CEO of the venture firm and the person responsible for the acquisition in the acquiring company as embedded units of analysis. We find that VCs passively contributes to the professionalization of the firms' formal control systems and routines through mentoring and controlling and through recruiting. Further, by including the acquirer, we find that a high standard in this area positively affects the financial DD and reduces the risk the acquirer associates with the deal.

To our knowledge, this is the first paper to include the acquirer's perspective on how a VC adds non-financial value to the portfolio firm. This methodology holds the promise of bringing clarity to the venture capital research domain, which is struggling to come to a conclusion of how and whether VCs adds value to their portfolio firms.

1 Introduction

A venture capitalist's (VC) ultimate goal in any investment is a successful exit, harvesting a handsome return to their limited partners and themselves (Burgel 2000). The most common exit routes are by an initial public offering (IPO) or through a trade sale. Trade sales are a primary exit for venture capital, and has become more prevalent under the current market conditions (Gompers & Xuan 2009; NVCA 2012; Ernst & Young 2011). Currently, trade sales have gained little attention from academics, partly due to the iron curtain of information associated with private acquisitions (Schwienbacher 2005). With the relative increase in trade sales and current gap of research, this paper contributes to unveiling some of the constructs within the "black box of trade sales." Trade sales are a critical feature of venture capital activity that warrants deeper study and exploration (Gompers & Xuan 2009).

The acquisition of new capabilities through the purchase of small start-ups is a strategy that has been employed by many large technology firms (Gompers & Lerner 2001) including Facebook, Zynga, Google, Cisco and Apple. In any M&A deal of a reasonable size the de facto standard is to perform a thoroughgoing due diligence (DD) of the targeted company, either carried out by the acquirer or a hired intermediary. The process should make the acquirer able to understand the risk associated with purchasing the company (Angwin 2001). The risk associated with asymmetric information and uncertainty prevents acquirers from distinguishing between higher- and lower quality firms and is particularly salient in entrepreneurial firms since the value in them often are intangibles assets, such as intellectual property, entrepreneurial teams' human capital and perceived growth opportunities (Gompers & Xuan 2009; Ragozzino & Reuer 2007). It is therefore clear that if the targeted entrepreneurial firm in addition to these challenges is encumbered with unstructured, inadequate or missing information with regard to e.g. intellectual property rights, legal contracts or financial statements, the acquirer or its intermediary might come to a conclusion that adversely affects the outcome of the DD either in terms of buy-decision or in the valuation which is prone to be risk-adjusted.

Several scholars have researched how some of the risk can be mitigated through informal mechanisms, such as a common VC investor or board member between the acquirer and the target (Gompers & Xuan 2009; Cai & Sevilir 2011) and formal mechanisms such as post-closing instruments, e.g. earn-outs and contingent value rights (Caselli et al. 2006; Kohers & Ang 2000). However, to our knowledge no research has been done to explore how the VC can play a role in preparing the investee for the DD which is an essential process to the acquirer in reducing the associated risk of the deal. Through an exploratory multiple case study of three recent Norwegian venture-backed trade sales, this paper aims at exploring the VC's role in this setting, and the following two research questions are sought answered:

> **RQ 1:** How does the VC contribute in professionalizing the venture-backed firm with regard to formal control systems and routines?
> **RQ 2:** How, if at all, do professionalization with regard to formal control systems and routines affect the financial due diligence process of the trade sale?

What sets this paper apart from previous studies of a VC's non-financial value-adding (NFVA) activities is the inclusion of a third perspective - the acquirer. Existing research is largely limited to exploring the VCs' NFVA activities from the perspectives of the entrepreneur, the VC or the dyad between them (Ehrlich 1994). We argue that by also including the acquirer, a more transparent picture of which VC NFVA activities actually create value, in the eyes of the acquirer who pays the price, can be derived. It can be argued that if an activity does not contribute to the premium paid by the acquirer, the VC should reassign priority to activities that do. To our knowledge, this is the first study to use this triangulation in a venture-backed trade sale context.

Based on our empirical data and arguments put forward in the discussion, we propose that the VC imposes formal control systems passively through monitoring and controlling and by engaging in the recruiting of key personnel to executive positions. This 'professionalization' is primarily done so that the VC can mitigate any asymmetric information endured by the principal-agent relationship with the investee and emerges as a necessity due to increasing complexity as the firm grows. However, we also propose that it has a secondary effect in that it makes the DD process run more smoothly, consequently reducing the total risk the acquirer associates with the deal. The latter sentiment is especially backed up in one of the cases included in the paper which portrays the potential catastrophic consequences in an acquisition if the financial DD is encumbered with inadequacies in financial information forwarded by the targeted venture-backed firm.

Based on these propositions, the paper has contributed to the research on venture capital trade sales by indicating that the VC's role in introducing formal control systems and routines in the venture-backed firm is a value-adding activity the acquirer's perspective. This triangulation would not have been feasible if the acquirer's perspective was not included, adding validity to the research design which holds the promise of introducing clarity to the inconclusive research on VC NFVA, as observed by Mason & Harrison (1999):

> Whether and in what ways venture capitalists add value continues to be a lively focus for debate, with no consensus on the answers.

The remainder of this paper is structured as follows. The next chapter presents the methodology used in the paper, providing an insight to the newness of the research design in the venture capital research domain. Further, in chapter 3 we develop a conceptual model of risk inducing and reducing mechanisms in a trade sale. This provides the frame of reference to chapter 4 which develops an exploratory model depicting relationships between VC NFVA activities, the financial DD and the risk associated with a trade sale. Chapter 5 and 6 gives an introduction to the cases and presents the findings. The following chapter provides a cross-case analysis of the findings which are used to discuss the theorized relationships of the exploratory model developed in chapter 4, and puts forward six propositions related to the model. The last chapter concludes, suggests implications for practitioners, and offers proposals for further research on the topic.

2 Methodology

The research design is a multiple-case, inductive study involving the trade sale of 3 venture-backed firms. Multiple cases enable replication logic where each case is treated as an experiment, allowing for confirmation or disconfirmation of inferences drawn from the others (Yin 2009). The case study research design is likely to have strengths like novelty, testability and empirical validity and is particularly well-suited to new research areas for which existing literature seem inadequate (Eisenhardt 1989), which is well aligned with this exploratory study. The research also uses an embedded design that includes the VC, CEO and a representative from the acquirer as the units of analysis. Although more complex, the upside of the embedded design is that it permits induction of richer, more reliable models (Yin 2009). Since this study pioneers the inclusion of the acquirer's perspective in research on VC NFVA activities, we elaborate on the methodology used so that future researchers seeking to endeavour on the same path may take advantage of our experience.

2.1 Research setting and motivation

We chose the financial DD in a venture-backed trade sale as our research setting due to the high importance acquirers put on it (Angwin 2001; Picot 2002). Moreover, an emerging strand of literature suggest that VCs participate in professionalizing the venture-backed firm (Hellmann & Puri 2002) and that the entrance of a VC precipitate the introduction of formal control systems and routines in the venture firm (Strauss et al. 2011; T. Davila 2005; Granlund & Taipaleenmäki 2005). We were therefore motivated to explore the existence of a link between the financial DD performed by the acquirer and the NFVA activities a VC contributes with as an active investor. We chose to investigate this premise by also including the acquirer's perspective, build on the rational that it may paint a more transparent picture of what VC NFVA activities contributes with in regard to the financial DD, and was also largely motivated by the fact that previous research in general is limited to exploring VC NFVA activities from the perspective of the entrepreneur, the VC or the dyad between them (Ehrlich 1994). In addition, trade sales as a whole has gained little attention from academics in the venture capital scene. This is mainly attributed to the limited publicly available data in private acquisitions (Schwienbacher 2005) in contrast to that of IPOs. This gap in current research and the importance of filling it, is further enhanced by the predominance of trade sales as the primary exit vehicle for VCFs (Gompers & Xuan 2009; NVCA 2012; Ernst & Young 2011).

2.2 Sampling

Given our research question about the VC's role in professionalizing the firm with regard to formal control systems and routines and what its effect may be in the financial DD process of a trade sale, we sampled Norwegian venture-backed firms that had undergone an industrial trade sale. After gaining access to a list of acquisitions, we shortlisted it to 6 potential cases based on the exit event's nearness in time. The reason for this was two-folded. Firstly, the likelihood that the informants accurately remembers the events are higher the less distant in time (Huber & Power 1985). Secondly, we expected it to be more likely to gain access to the person responsible for the acquisition at the acquiring company (PRAAC) the closer the acquisition date. The rationale was that organizational changes may come about over time in the acquiring company, i.e. employee turnover and career advancements. It proved difficult to get the attention of the PRAACs, primarily due to the unavailability of the person in question who often had executive positions in large offshore corporate companies, and the secrecy they put on such strategic issues. Since it was a prerequisite that we gained access to the PRAAC for the cases to be eligible, the list was further reduced to the three cases shown in table 1. One of the cases included (Thor) is distant in time, contrary to our selection criteria. However, being endorsed with the collaboration of the PRAAC proved so difficult, that we needed to lighten on the time constraint. The hardship in producing eligible cases including the collaboration of all of the three parties may be ascribed to the reason why such a study has not been conducted before.

Case	***VC***	***Target company***	***Acquirer***
Thor	Lead investor	CEO	Managing Director
Odin	Lead investor	Founder CEO	VP Corporate Dev.
Frigg	Lead investor	CEO	Head of SBU

Table 1: Overview of interviewees

2.3 Data sources

The study is based on several data sources: (1) qualitative data from semi-structured interviews with the VC, CEO of the acquired company and the PRAAC. (2) emails and phone calls to follow up interviews and (3) archival data, including company websites, press clippings and LinkedIn.

Due to the small sample of cases, we started with interviewing informants not connected to the cases who had considerable knowledge on acquisitions both on the buy-side and the sell-side and both of non-venture-backed and venture-backed firms. The interviews varied from 30 to 40 minutes and included one entrepreneur, two venture capital firms, three M&A advisory firms, one private equity fund and an interview with a private Norwegian company that recently acquired several non-venture-backed companies. The interviews followed a more open-ended format, with questions that often were idiosyncratic to the expertise of the informant. The interviews were formative in gaining an understanding of the acquisition and sales process in general and of venture-backed firms in specific, while also serving as a proxy to the triad between an entrepreneurial firm, the VC and the acquirer. The interviews were transcribed verbatim, totaling 53 single spaced pages, coded and grouped in categories based on Picot's (2002) overview of the five sub-analysis that a DD should include. This assisted us in developing relevant lines of questions for the distinct interview guides used during our main interviews and provided some conceptual clarification for the research questions.

The following two months we conducted 9 interviews with our key informants listed in table and 6 follow up interviews, varying in length from 30 to 60 minutes. All but one interview was tape recorded; in the one that was not, the informant exercised his right not to be recorded, and notes were taken instead. All the other interviews were transcribed verbatim, totaling 66 single spaced pages.

Our initial entry was made through the VC, who then identified and referenced us to the individuals relevant at the acquirer and the acquiree. By including all three parties involved in the trade sales we obtained the story from all the relevant perspectives of the trade sale, which helps mitigate subject biases in the accounts narrated (Golden 1992; Miller et al. 1997) and helps build a richer and more elaborate model of processes and events (Schwenk 1985; Yin 2009). Also, such highly influential and knowledgeable informants are the most reliable and are particularly so when recalling recent important events (Huber & Power 1985; Kumar et al. 1993). Considering that the VC and the CEO on the sell-side was generally more available, we interviewed them first before turning to the PRAAC. The logic was that the PRAACs were probable not to have in-depth knowledge of the events leading up to the trade sale, an insight that served an important foundation in constructing a 'mental storyboard' of how the entrepreneurial firms developed from an early stage to the exit event. Along with the acquiring companies' websites and press clippings, the 'mental storyboard' was helpful in gaining a better understanding of the acquirers' motivation to acquire the firm so that the time available for the interview with the PRAAC could be utilized effectively in uncovering relevant constructs and relationships with regard to the VC's NFVA activities.

Throughout our data collection, we took steps to minimize informant biases. The interviews with the VCs and the venture-backed firms began with them giving a description of accounts leading up to the exit process. When seeking retrospective reports, such an open-ended question primes the interviewee to recount details from the specific case, rather than general notions, and should lead to higher accuracy in our data when we asked more specificity demanding question (Lipton 1977; Miller et al. 1997). In addition, the authors emphasized the importance of focusing on facts and events, rather than on respondents' interpretations, especially of each other's actions (Eisenhardt 1989). Acquisitions and trade sales are a delicate matter to the parties involved, especially the acquirer. Consequently, to motivate our informants not to hold back on information, we promised confidentiality (Huber & Power 1985; Miller et al. 1997; Yin 2009).

2.4 Data analysis

After completing the initial interviews with all the informants in table 1, we analyzed the data by first extracting quotes, coding them with keywords and further tabulating the three perspectives within-case. This enabled us to perform "triangulation" between the interviews of the triad and was a central aspect in our case writing, outputting rich and more reliable accounts of the processes during and pre-exit (Jick 1979). A core aspect of the inductive process was that we allowed constructs to emerge from the data, rather than being guided by specific hypothesis. Although we early on noticed similarities and differences between the cases, we strived to not perform any analysis cross-case, thus maintaining the independence of the replication logic.

Following the within-case analysis of the embedded units, we utilized the standard cross-case analysis technique (Eisenhardt 1989), looking for similarities and differences between the cases. Through replication logic, we developed initial propositions on the relationships between VC NFVA activities and the effects on the financial DD of a trade sale. We often revisited the data, and as constructs, causal relationships and tentative propositions emerged, we found the need to follow up the initial interviews with interviews of the informants from the venture capital firms and the CEOs of the acquired company. Since the study is exploratory in its form, the follow-up interviews helped us to perform a "sanity check" of the developed tentative propositions and accompanying argumentation, verify that we had understood the accounts given correctly and receive further comments on accountants relevant to the tentative propositions that were not fully covered during the more open-ended initial interviews. This ensured a closer relationship with the exploratory models developed in the discussion and the world as perceived of the practitioners.

2.5 Information sensitivity

The informants linked to the three cases expressed that the information provided in the interviews is very sensitive. This became evident in the feedback the authors received during cite-check, and is demonstrative of the immense secrecy and delicacy especially the acquirers put on acquisition processes, and proved to be a real headache to the authors.

Several of the quotes sent were adjusted to be more 'politically correct', reducing their usability, while some quotes needed to be completely removed on the informants' request, with one informant stating that the quotes needed to be redacted due to legal reasons. This property was especially noticeable in one of the cases where the situation that arose between the target and the acquirer almost caused the acquirer to walk away from the deal. The censoring of quotes might be ascribed to the informants' fear of offending any of the other two linked parties which were interviewed. Taking the informants' perspective, the fear is not without reason. Research is well aligned on the importance to the acquirer that the employees of the targeted firm join the acquirer's organization post-deal (see e.g. Hambrick & Cannella 1993; Ooghe et al. 2006; Ranft & Lord 2000). Accordingly, the major part of the targeted company's organization is still employed with the acquirer, and any accusations or negative comments might negatively impact the formal and/or informal relationship of the linked informants. Although all informants were given pseudonyms, anonymizing their identity, any reader with intimate knowledge to the case would be able to realize which acquisition a case describes. This section adds to the authors' suspicion of why such studies have not been conducted before; namely the hardship endured in gaining access to reliable sources and informants and the potential bias in the accounts given, if successful.

2.6 Limitations

This study is based on a sampling of three completed Norwegian trade sale exit process and as such the results are not statistically significant. Due to the geographically small focus and lack of cases across several industries, the external validity of the study may be argued to be less and thus regarded to not be generalizable to the general population of venture-backed trade sales. Although we took steps to minimize informant bias, we cannot be sure that we were fed subject portrayals of accounts and events that may have affected the objectivity of our data. As mentioned, biased and filtered accounts may be particularly salient in the three cases described in this paper, reducing the reliability of the empirical data.

3 Frame of reference

To explore our research questions, we will first review literature from the M&A and venture capital research field. The following section will more specifically look deeper into some of the risks associated with acquisitions of venture-backed firms and measures employed to mitigate it from both sides of the table. These mechanisms are summarized in a conceptual model (figure 1), serving as a frame of reference for exploring how the VC might play a role in this setting.

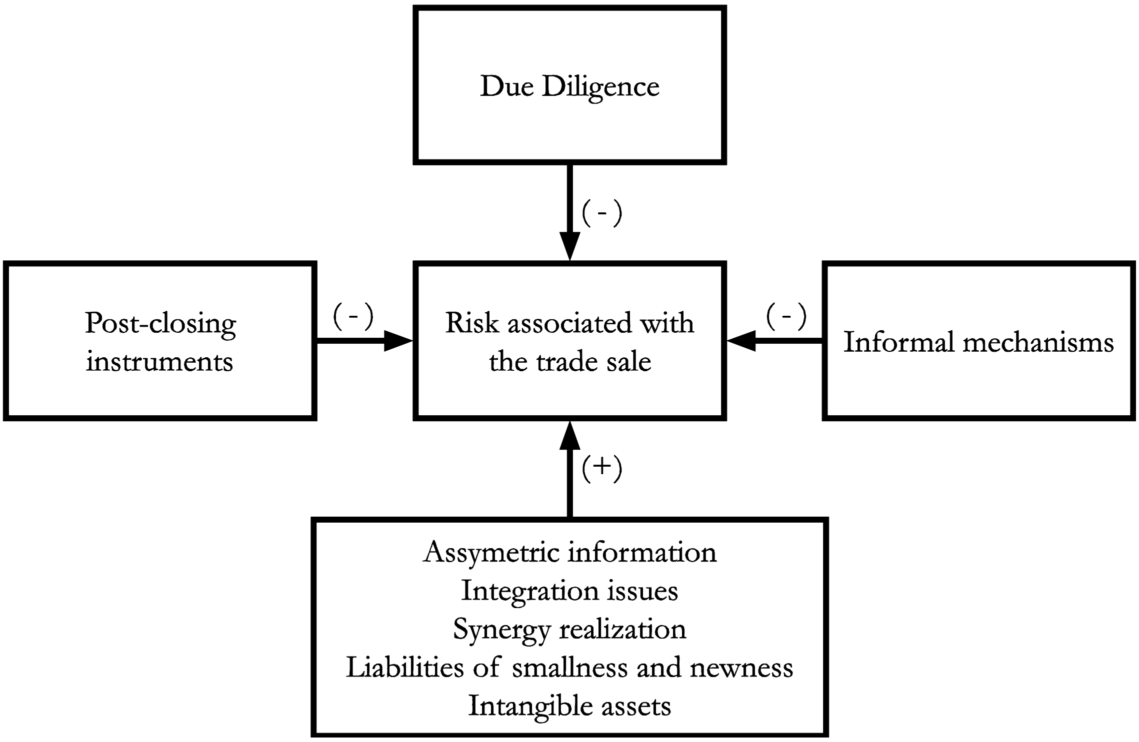

Figure 1: Conceptual model of risk reducing (-) and inducing (+) mechanisms in a trade sale. The model is produced by the authors.

3.1 Risk inducing mechanisms

Young venture-backed companies often develop innovative technologies that can be exploited by larger established companies through acquisitions (Gompers & Lerner 2001), a strategy that has been employed by e.g. large technology firms including Facebook, Zynga, Google, Cisco and Apple. No matter the size of the acquiring company, acquisitions are a challenging and complex endeavour which carries with it big risks of failing to uncover pitfalls related to asymmetric information, integration issues and the realization of synergies (Kitching 1967; Yeheskel 2004; Larsson & Finkelstein 1999). These risks are more apparent in transactions involving the acquisition of small firms that have yet to overcome liabilities of newness and smallness typically associated with new ventures, compared to mature companies with longer operating history and a more clearly defined organization, financial structure and market size (Ragozzino & Reuer 2007). In addition the value inherent in entrepreneurial firms often are intangibles assets, such as intellectual property, entrepreneurial teams' human capital and perceived growth opportunities, all which adds to the uncertainty of future performance.

3.2 Risk reducing mechanisms

As an utility to mitigate some of this risk in an acquisition, it is the de facto standard to perform a thoroughgoing DD of the targeted company in any deals of a reasonable size, either carried out by the acquirer or an hired intermediary (Angwin 2001; Picot 2002). Other risk reducing mechanisms of a trade sale may include informal ones, such as sharing a common investor or board member between the acquirer and the target and post-closing instruments such as earn-outs and retention bonuses. These mechanisms will be reviewed in short in the following sections with the purpose of establishing a frame of reference to the 'risk reducing toolbox' the parties of a venture-backed M&A deal possesses, which in turn will form the backdrop of a our exploratory model in the next chapter.

3.2.1 Informal risk reducing mechanisms

Several scholars have explored how the risk inherent in acquisitions of young venture-backed companies can be mitigated through informal mechanisms. The research has primarily centered on different aspects of how social and financial ties between the acquirer and the target can mitigate some of the risk and the legitimating effect of being a venture-backed start-up.

Gompers & Xuan (2009) and Cai & Sevilir (2011) show that a common link such as a common venture capitalist or a common board member between the target and the acquirer helps to reduce the information asymmetry associated with a transaction. Moreover, their results indicate that an acquisition is 3.5 to 3.8 times more likely to take place when there is a common VC linking the acquirer and the target. Kamath & Yan (2010) also find that VCs facilitate the matching of merging firms by reducing information asymmetry, but that their primary incentive is to extract rents from the acquirer shareholders. A recent anecdotal acquisition can be suspected to have shown this property. When Facebook acquired the photo sharing mobile application company Instagram at a valuation of $ 1 bn in April 2012, the renowned US venture capital firm (VCF) Andreessen Horowitz reportedly held a 7 % stake in Instagram, while also holding equity and a seat in the board of Facebook[1]. In another more distant notable acquisition, the US VCF Sequoia Capital held financial positions in both Google Inc. and the 18-month old YouTube when Google acquired YouTube at a valuation of $ 1.65 bn in October 2006. The New York Times quotes an insider of the deal:

> The fact that the man who is perhaps Sequoia's best-known partner, Michael Moritz, sits on the board of Google could have given the search giant more insights into the legal risks associated with YouTube, and therefore more confidence in pursuing a deal.[2]

Also, the infusion of venture capital is considered as a signal of quality. The legitimation role of the VC is an important VC NFVA when exiting through a trade sale since they are "staking their reputation" on not selling overvalued assets (Gompers & Xuan 2009). However, other scholars have found that the legitimation role plays a more important part in IPOs (Cumming & Johan 2008) and that VCs display a rent-seeking behavior towards the buying party when liquidating their investments, which may counteract the positive effects of legitimation (Kamath & Yan 2010).

3.2.2 Formal risk reducing mechanisms

3.2.2.1 Due Diligence

The DD process is a pre-closing instrument put in place to make the acquirer able to understand the risk associated with purchasing the company (Angwin 2001) and is a 'comprehensive analysis of the target company's business - its strengths and weaknesses - its strategic and competitive position within the industry' (Kissin & Herrera 1990). With this in mind, Perry & Herd (2004) hypothesizes that the DD should influence the premium[3] the acquirer pays for the target which is further supported by Wall & Smith (1997) who indicate that price may be increased by ensuring that adequate information is available. Picot (2002) gives an overview of the DD process, and introduces sub-analysis that a DD should include. He finds that financial and legal -, market -, human resources -, organizational - and information technology (IT) DD are the most common. For the remainder of this paper, we focus on the financial DD.

Financial DD is concerned with the financial numbers of the company being acquired. The focus is not only to uncover the financial past, but also to make sure the financial structure is

[1] http://articles.businessinsider.com/2012-04-10/tech/31316849_1_facebook-board-kevin-systrom-venture
[2] http://www.nytimes.com/2006/10/10/technology/10payday.html?_r=1&pagewanted=print
[3] Acquiring companies always pay a substantial premium due to the belief that extra value can be harvested (Sirower & O'Byrne 1998).

sustainable (Howson 2003). The financial DD is a prerequisite for an M&A deal and often poses as a 'go' or 'no-go' conclusions for the acquirer (Harvey & Lusch 1995). Wall & Smith (1997) therefore stress the importance of providing adequate and precise information during the DD, which can only be done by having professional and expositive financial statements and reporting systems. At the point of an exit, it is often too late to address these issues (Wall & Smith, 1997).

3.2.2.2 Post-closing instruments

After the closing of the deal, a major risk to the acquirer is the potential of failure of the target to perform up to expectation, implying overpayment of the company. An instrument employed to mitigate this risk is the use of earn-out agreements (Caselli et al. 2006). The top management and the founders of the targeted firm often holds stock in their company, and earn-outs are designed to shift the risk of overpayment and sub-performance from the acquirers to the stockholders of the target by deferring a percentage of the agreed price until certain goals are met (Kohers & Ang 2000). Since an earn-out agreement affects all the shareholders of the target, the VC will usually take part in the negotiation of the terms, e.g. at what key performance indicators the earn-out is liquidated.

Of the three mechanisms described in this section, current literature indicates that the VC can partake and play a role in mitigating risk through informal mechanisms and in the negotiation of potential post-closing instruments, while little has been done to explore how the VC can contribute with NFVA activities that formally reduce risk in the DD of a trade sale. Since it is a prerequisite that 'the numbers add up' in the lion's share of trade sales, we turn our focus to further develop an exploratory model of how the VC's role may come in play from a financial DD perspective.

4 Theoretical framework

In the early phase, the start-up firm is typically run by its original founders and displays a control structure more similar to 'organized anarchy' than to that of a business organization (Strauss et al. 2011). The firm is run by informal control mechanisms such as shared beliefs (Granlund & Taipaleenmäki 2005), a 'self-motivating fun culture' (Mouritsen & Kreiner 2003) and entrepreneurs often abhor the implementation and use of formal control systems (Lukka & Granlund 2003). However, if the start-ups grow in e.g. headcount and production capacity, this informal control structure becomes challenging since the span of controls becomes too large (T. Davila 2005) and decision-making based on direct personal information becomes almost impossible (A. Davila & Foster 2005). This growth stage is often associated and enabled by the infusion of venture capital (Zider 1998) with VCs taking an active role in their investment (Busenitz et al. 2004; Steier 1998) and is found to contribute in professionalizing the firm (Hellmann & Puri 2002). Furthermore, VCs accelerate the introduction of formal control systems (Strauss et al. 2011) that, as indicated, might be less developed or non-existent in the entrepreneurial firm before the infusion of venture capital; especially if the entrepreneurs have a strong technical or scientific background (Ehrlich 1994). With the emphasis the acquirer puts on the financial DD in an acquisition, these VC NFVA activities are important in preparing the firm for such an event. With this as a backdrop, the following section uses prior research on VC's NFVA activities to develop the rationale behind the relationships (1), (2), (3) and (4) in the exploratory model depicted in figure 2.

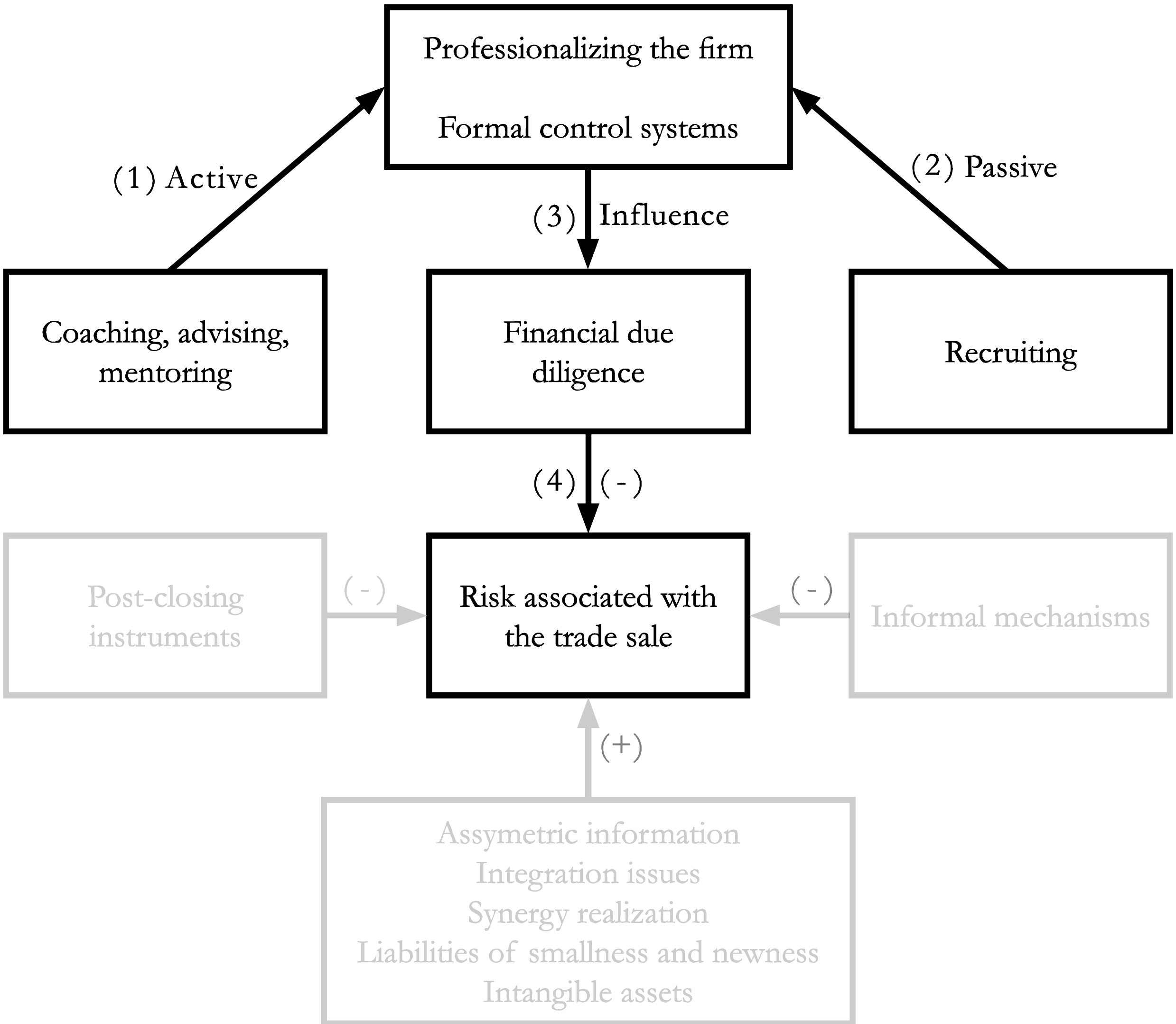

Figure 2: An exploratory model showing the relationship (1) and (2) between the VC's NFVA activities and the professionalization of formal control systems and routines and the possible influence on the financial DD (3), and ultimately the risk associated with the deal (4). For clarity and reference, the conceptual model from figure 1 has been included with the parts not relevant for this chapter made transparent.

4.1 Preparing for the financial due diligence

Since the VC often enters an entrepreneurial firm in its early stage, we theorize that the VC plays a role in professionalizing it, in particular by introducing formal control systems and that the degree of importance put on this, may positively influence the outcome of the financial DD thereby reducing the total risk associated with the transaction.

4.1.1 Professionalization of the venture-backed firm

Hellmann & Puri (2002) found that the venture capitalists play a role in the professionalization of start-ups, such as human resource policies, the adoption of stock plans, and the hiring of marketing VP. On the other hand, they do not put in concrete terms what they mean by 'professionalization'. In order to establish a common ground, we conceptualize professionalization of a start-up as:

> The process of transitioning towards an organization reflecting causal logic in the way the firm operates, organizes and is governed, i.e. evolving into an organization resembling that of a traditional business.

A criticism of this conceptualization is valid. Watson (1995) criticizes the general notion of the existence of a sequential transitional process in the development of businesses. However, any model or process of entrepreneurship must take into account the stage of development of the business (Chell et al. 1991) and our approach to such a transition incorporates the entrance of VC, which in the lion's share of cases is argued to indicate a 'new' (growth) stage in the entrepreneurial firm and which will impact its business (Zider 1998). Still, the conceptualization of professionalization do not imply that the entrepreneurial firm always is in an early fluid and disorganized state, and that the VC consequently will induce a transition in which the venture-backed firm settles into a rationally planned tightly-integrated and formalized system. E.g. are VCs found to be less active when founders have prior business experience, have achieved previous successful exits, or if the company is already well on track and the founders can point to having achieved some milestones (Hellmann & Puri 2002).

Further, it is obvious that the term professionalization and our definition is somewhat general. One could argue that most of the NFVA activities a VC participate with, could in turn add to the professionalization of the firm. With our focus on the financial DD in trade sales, and what might contribute to mitigate the risk therein, we therefore turn to explore how the VC may contribute in the professionalization of the firm in this setting.

4.1.2 (1) Active professionalization through mentoring, advising and coaching

Several authors have researched the emergence of management control systems[4] (MCS) in start-ups and what the drivers are to implement them (see e.g. Strauss et al. 2011; T. Davila 2005; Granlund & Taipaleenmäki 2005). In a qualitative cross-sectional field study of 20 German venture-backed early stage firms Strauss et al. (2011) find that the entrance of a VC significantly precipitate the adaptation of MCS and that financial and human resource planning are the first categories of MCS introduced. A reason for VCs to accelerate the implementation of MCS, can be found in agency theory. It lies in the VCs nature, as the principal with the entrepreneurial team as the agent, to employ measures which enables the VC to monitor and control the investment in order to combat asymmetric information, and it is one of the most specific VC activity described in the literature (see e.g. MacMillan et al. 1989; Gomez-Mejia 1990; Ehrlich 1994; Sweeting & Wong 1997). If the venture-backed firms have not already employed the use of routines and formal procedures to codify the information required by the VC, the VC will usually impart critical knowledge and experience by coaching, advising or mentoring the new venture team (Gorman & Sahlman 1989; MacMillan et al. 1989; Sapienza 1992; Sapienza & Korsgaard 1996; Hellmann & Puri 2002), e.g. by giving them financial, administrative and management support; an activity we label 'active professionalization' since this is a 'hands-on' activity.

4.1.3 (2) Passive professionalization through recruiting

VCs have been found to participate in recruiting activities and in particular to executive positions (Timmons & Bygrave 1986; Gorman & Sahlman 1989; Ehrlich 1994; Hellmann & Puri 2002). It is however rare to find term sheets allowing the VC to hire non-executive managers (Sweeting & Wong 1997). The recruiting activity contributes to the introduction and professionalization of formal control mechanisms as experienced management with solid business skills are introduced to the organization and bring with them their system of belief, business acumen and formal control mechanisms (Greiner 1998; Greiner 1972; Daily & Dalton 1992). We label the recruiting of experienced management as 'passive professionalization' since the activity is 'at an arms-length' in relation to the professionalization of formal control mechanisms.

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[44] [4] MCS can be defined as formal, information-based routines and procedures managers use to maintain or alter patterns in organizational activities (Simons 1995). Throughout the paper, we denote this concept 'formal control systems and routines'.

4.1.4 (3) & (4) The effect on the financial due diligence

In the conceptual model (Figure) depicting risks associated with a trade sale and the different mechanisms to mitigate it, financial DD is an embedded sub-analysis of the DD process (Picot 2002) and its positive outcome is a prerequisite for the acquirer (Wall & Smith 1997; Harvey & Lusch 1995) since it is the basis for which the acquirer evaluates the financial past and structure and makes sure the latter is sustainable. It is also the basis for which the acquirer calculates potential financial synergy effects (Picot 2002) such as revenue enhancements, cost savings, process improvements, financial engineering and tax benefits (Eccles et al. 1999) and thus is one of several factors that affects the premium paid (Sirower & O'Byrne 1998). Taking into account that risk associated with asymmetric information and uncertainty is particularly salient in the acquisition of young venture firms (Gompers & Xuan 2009; Ragozzino & Reuer 2007), it is clear that if the venture firm in addition is encumbered with unstructured, inadequate or missing information with regard to one of the risk reducing mechanisms – e.g. the financial DD, it may increase the risk associated with the deal. With the premise that the relationships (1) and (2) holds true, these VC NFVA activities should positively affect the financial DD performed on the firm in a trade sale, and indirectly the total risk in the deal, as illustrated by the relationship (3) and (4) in Figure 2.

5 Presentation of the cases

Serving as an introduction to the findings presented in the next chapter, we provide the reader with a short introduction to the three cases.

Case	***Industry***	***Investment duration [years]***	***Deal size [MNOK]***	***Acquirer revenue [MNOK]***
Thor	Hardware & Software	3	14	~ 1000
Odin	Software	10	Undisclosed	~ 605
Frigg	High-tech	6	900	~ 6000

Table 2: Overview of cases

Thor was an early investment made by the VC due to his belief in a growing market. The company developed a combination of software and hardware and the VC exited in three years. With a deal size of only 14 MNOK, the VC agreed that the return was not magnificent, but he deemed it as an 'ok' investment, and a good exit compared to what they came to expect. The acquiring company was a large company with about one bill NOK in revenue, and the acquisition was considered very successful from the acquirer's perspective.

Odin was a long investment for the VC; it took 10 years to exit the business. The company survived several macroeconomic crises, but the market distress largely influencing the projected growth plan. There were several owners, but the VC was the chairman of the board and lead investor. The deal size remains undisclosed, but with the acquiring company having only 605 MNOK in revenue, the deal size is most likely in a range that deems the exit as only moderately successful. Much of the compensation was based on performance following the acquisition.

Frigg was a large investment, and later stage than Thor. The company had a high tech product, and they needed substantial funding to scale the business. The VC exited the company six years later and harvested a generous return, making the exit very successful from the VCs perspective. The large acquiring company, with revenue of 6 billion NOK felt they had to dig very deep in their pockets to acquire the company.

6 Findings

6.1 Thor

In advance of the VC's investment in the technology company founded by students, it was agreed to that the current CEO should be replaced by a more experienced one. The VC explains their rational of recruiting a new CEO:

> … they [the new venture team] all had technical backgrounds and we brought in a new CEO, whom we knew, to lift the company. (...) We are always very operational, so the first thing we did was to hire the CEO because of his experience from the industry (Thor VC).

When the new CEO was hired, he experienced the company to be in pretty good shape with regard to the state of formal control systems. The VC did not view their role in introducing new routines related to this part of the firm as very active, but was more concerned with developing the business strategy and product mix; an opinion backed up by the CEO. The VC did however get involved with regard to reporting with the purpose of managing and monitoring their investment:

> We [the VCF] worked a lot with the company and the CEO on how to report and industrialize the business, these are measure we put in place to manage and control the firm. This is just normal procedure since we want to develop a good company and not specifically related to the exit. At the point of exit, it is too late to do anything with this (Thor-VC).

It seems like the hiring of the CEO played a larger part in professionalizing the company. Interestingly, the CEO put forward a partial proactive view of this activity in relation to the exit.

> When I was hired as the CEO, a natural part of my job was to make sure that we had all the formal documentation in shipshape. Since I knew we were going to sell the company, we needed to have everything accurate, well arranged and tidy. We had that in mind from day one really, but in addition you save a lot of time by doing this since you don't have to deal with all sort of trouble that might emerge if you don't (Thor CEO).

When asked whether the CEO's role in 'internal housekeeping' might have influenced the price the acquirer paid, the CEO responded:

> … you never get credit for that. It's just something they expect to be in place, and it isn't something you can negotiate price on. It's more the other way around. If something isn't like they expect it to be, that will increase the risk which means they will scale down on the price (Thor CEO).

The acquirer found the acquisition to be very effective, and through discussions and meetings with the management they gained a well-founded understanding of "(…) what the company was made of" and "(…) its substance, and what their thoughts were about their products". They also gathered intelligence through the DD that they performed on the target themselves.

> … we ran a series of financial and legal due diligence that made us understand whether an acquisition was realistic or not, especially whether our valuation of the company and their asking price was in the same ballpark. (...) We experienced the due diligence as effective, we got access to information relatively quick and easy and the information we got was 'alright' (Thor acquirer).

The interviewee from the acquirer had also been involved in the acquisition of two other privately held companies and put forward his view of the difference when acquiring them, compared to the acquisition in the Thor case and relates this to the price-risk aspect of a deal.

> My experience is that the negotiation process is slightly harder when a company is venture-backed; the VCs know their 'excel'. On the other hand, venture-backed companies reflect another level and structure; there is a higher degree of professionalism. Venture-backed companies live under a stricter regime, especially with regard to reporting routines. This is often reflected in the price at the exit, since it reduces the risk of the transaction (Thor acquirer).

6.2 Odin

The quotes and data provided in this case have been heavily adjusted, with multiple quotes being removed on the informants' request. Consequently, several of the observations are based on the author's perception of the events that occurred.

In the Odin case, the VC indicated that he played a role in improving and introducing formal control systems and routines in the portfolio firm and related this activity to monitoring and mentoring, but also added the interesting remark that he generally perceives these areas as underdeveloped at the time of investment.

> A long time has passed since we first invested [in the new venture] so it's a bit difficult to remember, but I mean, it's certain that we all the way gradually introduced and improved both financial- and reporting routines and systems. The motivation is to get the reporting on a format that enabled us to extract the information we needed. Empirically, this function is not very developed in the companies we invest in (Odin VC).

However, the VC's role might have been less active due to the high confidence he had to the founder CEO. Illustrative of his faith in the CEO is the 'protective hand' the VC put over the CEO when several board members voted to fire him as a consequence of a bad acquisition in which the CEO was the promoter; the acquisition nearly led the venture firm to go into bankruptcy. The venture-firm was also severely impacted by the macroeconomic crisis in 2001 and 2008. The former led to a large reduction in the workforce and the relocation of the head quarter back to Norway. In this process the current CFO left, and a new one had to be hired.

> … that's when we recruited a CFO through the VC's network; the VC also participated in the interviews. Together, I and the new CFO put the required reporting systems in place (Odin CEO).

Somewhat surprisingly, the new CFO did not have an official education within accounting, but had previously been the CFO of a small company and done some consulting work within financing, M&A and restructuring. However, things got complicated during the DD, as described by the CEO.

> The due diligence process wasn't without complications. A couple of times we responded a tad too fast, and forgot to ensure that the information we supplied were of 100 % quality. At one point in the due diligence, our CFO sent a forecast to the acquirer that showed incorrect growth parameters. (...) That led the acquirer's calculations to go to smithereens, and their confidence to our CFO was ruined. That almost killed the deal, and we had to do a light audit in order to regain trust (Odin CEO).

When asked about this situation in the interview with the acquirer, the financial DD proved to be a big issue to them in the acquisition process, and the authors got a sense that the troubles experienced in this process almost became a deal breaker. Indicative of its importance, the acquirer emphasized the 'numbers bit' as one of the most important aspects of an acquisition.

> The due diligence process was 'OK'. Overall they did a pretty good job of pulling it together in all the right structure, and making sure a lot of the information was available, like customer contracts and all that sort of thing. Unfortunately the most important part of any due diligence, it is the numbers bit, and the numbers very challenging due to the quality of some of the financial information (Odin acquirer).

> This [the situation that arose] caused us to spend more time on the deal, so our costs went up. We ended up spending significantly more on financial due diligence, than we had budgeted. There became a big question which is, 'is this really the business they say it is?', which is a natural question to ask through every single M&A process. We did the extra due diligence work and proved 'yes, the business was the one we wanted to be part of our story' (Odin acquirer).

When asked to elaborate on how this situation arose, the acquirer explained that when they gathered intelligence on the top management team of the target through LinkedIn. When the authors checked secondary data, it showed that the CFO does not have a proper accounting background, but had some financial experience from previous engagements prior to the employment in the targeted company. During the interview, the authors got a strong feeling that the acquirer attributed several of the misgivings during the financial DD to the CFO of the target, and that they lacked confidence to the financial statements and models that were provided. This may be the reason why the acquirer took a more thorough and investigative approach, since the financial DD is seen as a prerequisite.

> Our challenge with the financial information led us to undertake much more detailed financial DD supported by our partners [the advisor], and with the target company also engaging with their own auditors. This process involved detailed analysis of balance sheet, cash flow, etc. until all parties were 100% clear. This was a painful process, and had the potential to derail the acquisition as it added time and cost to both parties. In the end, the co-operative approach of all parties meant we re-built trust and completed the deal (Odin acquirer).

From the authors' view, it is likely that the acquirer did not view the initial financial DD as satisfactory and mostly blamed it on the adequacy of the CFO. Both the VC and the CEO added their comments, indicating that some trouble arose in the DD. However, they downplayed the situation and opinioned that the acquirer also had a part in the contention during the DD and that there was a personality mismatch between their CFO and the DD team of the acquirer.

> … the CFO did some unfortunate mistakes, which led the acquirer to take several other non-related things in doubt. In my opinion, the CFO on the other side of the table was difficult to deal with (Odin VC).

> In a couple of occasions, we supplied the acquirer with some information that wasn't properly quality assured, and that created a lot of turbulence. The CFO was a key figure, but he got into a quarrel with the new owners. After these incidents, they didn't trust our numbers anymore, and we had to perform a full audit in the middle of the due diligence. The result from the audit was actually better than what we had thought on beforehand (Odin CEO).

When asked whether the situation in any way affected the premium, the acquirer recalled that it probably didn't, but that it did affect the way the deal was structured with earn-outs.

6.3 Frigg

Compared in deal size and return on investment, the acquisition in the Frigg case was the biggest exit included in this paper. The venture-backed firm achieved considerable growth, and the introduction of more formal control systems and structure became important. The VC played a role in this process, but evidently mostly by hiring professionals into the organization, indicated in comments made by the VC and the CEO, respectively.

> We [the VCF] have had a continuous focus on e.g. professionalizing reporting routines. When we invested, the turnover was about 100 MNOK... things tend to get more complex as you grow, especially with internationalization, foreign currency etc. That requires a lot more professionalism than when they were a small shop. After we invested, we required monthly reports, and we continuously worked to make them better (Frigg VC).

> The VCF didn't really help us in professionalizing reporting, financial and contracts, but they contributed in the way that they saw that we needed help on the financial and HR part of the company. It was mainly through these two people that we got some more of the formal structure in place. (...) [the company] was going to enter a significant international growth stage, and we needed to professionalize these areas (Frigg CEO).

The effort the VC put into hiring the CFO support the sentiment that this person was of particular importance to them. When the CFO was to be hired, the venture firm first put forward a candidate they thought would be suitable for the job, but after the VCF had interviewed the person in question, the candidate was rejected. Instead, they sourced a candidate from their own network that was hired, sidestepping their normal operating procedures of not intervening in the daily operations by doing so:

> Normally we don't dictate who should be a part of the management team because of our firm belief that we shouldn't involve ourselves in the operation of the company, but the CFO is one we need to have full confidence to. Therefore, we participated in the hiring process including the interviews, of the CFO (Frigg VC).

However, the VC indicated that they do not align their actions to the exit strategy, but focused on creating value in their investee.

> Our top priority is to create the most value in the company. I believe that if you have an extreme focus on the exit and it affects how the company is run, you're ruining it for yourself. We were prudent not to make a lot of tactical choices in relation to whether the

> acquirer appreciates this or that, firstly you don't know who's going to end up buying the company, secondly, you don't know what they want (Frigg VC).

The trade sale was performed as a structured deal, with an investment bank as the broker. Both the VC and the CEO expressed that this contributed in facilitating the deal, among other things since it included a vendors DD and brought with it a signal of quality to the potential acquirers.

> … our broker had very high quality standards which played a part in getting everything sorted out before any potential acquirers started digging (Frigg CEO).

> We did a vendor due diligence - it's reassuring and you can frontload some of the work, especially if you expect several buyers. This also enabled us to perform a thorough 'spring cleaning' of the company (Frigg VC).

The results from the DD were positive in that it did not bring up any big issues, reflected in the VC's following comment.

> It wasn't raised many issues during the due diligence, but i mean, if you send in a bunch of accountants and lawyers, something will surface, but in [the investee] it was mostly small issues. [The target company] had everything well organized (Frigg VC).

Returning to the hiring of the CFO (and the HR manager), the CEO credits them for the part they played in professionalizing the company's internal affairs prior to and their role during the DD.

> The HR and CFO function was paramount in the exit process. The HR manager was also a resource in the legal department and had previously worked with investments as a CFO, and both of them was vital in the professionalization process of the financial and legal aspects of [the company]. The financial due diligence was cardinal to our buyer, and the paperwork thus had to be spotless (Frigg CEO).

The acquirer gave insightful comments of their view about the financial DD process and is clear in their view of its importance in relation to the risk of the deal.

> The quality and the extent of the data we got during the due diligence were fundamental to mitigate the risk in the deal. I mean we had to know about some of the technology contracts, about the customer contracts and most importantly we had to know that the very optimistic picture of their business in the coming years was based on real assumptions. Otherwise, whenever you are determining the value, the price you have to pay, the multiple, you have to base it on where you expect the business to go. So that was absolutely key in understanding what the assumptions are. It wasn't as much the values they used, but the assumptions behind the numbers (Frigg acquirer).

The acquirer continued by painting a picture of what might be the consequence if the quality of information provided had been inferior. Given the comment above about the 'assumptions behind the numbers', the acquirer put emphasis on how this may influence their view of the quality of the management.

> If the data was of low quality, that would have affected the outcome with regard to buy decision and the premium in two ways. One, if the numbers don't seem stable or realistic and of good quality, you can't use them, and you have to scale back [the price]. More importantly, if the numbers that the management has produced don't seem realistic or have weak assumptions, you have to worry about the management. 'What's wrong with these guys, are they living in co-co-land? Are they naive, are they trying to pull a fast one or are they ill informed.' It is hard to determine which one is which (Frigg acquirer).

In the final comment included in this case, the acquirer expand on how the VC may play a role in preparing the portfolio company for a trade sales, and make remarks in relation to non-venture-backed firms and how they tend to underestimate the importance of formal control and reporting routines.

> I think one of the things the VC company should bring, is that they should know the expectation of any buyer. You know, process, and therefore not should they only have the data all together, but they should coach the company in a way that makes them at least appear to be professional. Often times when you look at companies which are not venture-backed, but are organically grown, you find that they don't understand the value of fully audited financial reports. (...) and a lot of smaller companies that don't have financial backing from VC companies, or at least good VC companies, sometimes

underestimate that. And when you come to the due diligence you find a lot of uncertainty, and that sometimes causes the deal to fail or lower the value. More risk means lower value, and you pay less (Frigg acquirer).

7 Discussion

7.1 Research Question 1

In research question 1, we asked how the VC contributes in professionalizing the firm with regard to formal control systems and routines. In our exploratory model (Figure 2) of this activity, we proposed the existence active professionalization (1), a hands-on approach through mentoring, advising and coaching, and that they also approached the issue passively through recruiting (2).

7.1.1 Relationship (1): Active professionalization through coaching, advising and mentoring

In all three cases, the VC commented that they continuously worked with their investees to improve reporting routines. None of them indicated that this was a proactive measure serving as a preparation for an upcoming liquidity event or financial DD, underlined by the Thor VC who commented that it is just a normal procedure they employ with the aim of developing a good company, and not specifically related to exit. Not surprisingly, the consensus among the VCs was that their involvement to this regard was motivated by their need to monitor and control their investment. This finding is in line with agency theory and previous research that has found monitoring and control to be one of the most specific VC activity (see e.g. MacMillan et al. 1989; Gomez-Mejia 1990; Ehrlich 1994; Sweeting & Wong 1997). Formal monitoring is crucial for VCs to combat the lack of information (Sahlman 1990; Shane & Cable 2002). On the other hand, all the representatives of the venture-backed firms agreed that they did not experience their respective VCs to play an active role in introducing and improving formalities of the company, e.g. by instructing them to introduce 'this' or 'that' control system or routine, an observation in line with MacMillian et al. (1988) who found VCs to be least involved in the operational functional areas of their investee. At first glance, there seems to be a conflicting view between the CEOs and the VCs about what the VC participated with in this regard, similar to Gomez-Mejia (1990) observations who find that CEOs and VCs hold opposite views about the VC's contributions to the internal management of the firm. An explanation can be found in that the CEOs are very operational; they (or their CFO) are the ones that need to make the changes or improvements that the VC demands happen. Thus, they may not view the advising or coaching role of the VC as the act that improves them, and we do not argue that it is. However, the consenting comments made by the VCs that they continuously worked to improve the reporting routines indicate the existence of a feedback loop with the intent of communicating whether the quality of the reporting is at par or inferior with the standards expected, a conception similar to Ehrlich's (1994) findings. A contrapositive argument supporting this can be made: if the feedback loop did not exist, the reporting may not have been improved as much as when the feedback loop is present. Two of the acquirers and one of the VCs commented that the formal control systems and routines in non-venture backed companies are not very well developed; further supporting the notion that a feedback loop involving the VC may serve as a function in improving these areas, and that the VC imposes higher standards than the entrepreneurial firm would exercise themselves. The arguments made that the VC plays a role in this setting are supported by previous research that have found the VC to usually impart critical knowledge and experience by coaching, advising or mentoring the new venture team (Gorman & Sahlman 1989; MacMillan et al. 1989; Sapienza 1992; Sapienza & Korsgaard 1996; Hellmann & Puri 2002), e.g. by giving them financial, administrative and management support.

In our exploratory model (Figure 2), we explored the notion that coaching, advising and mentoring the venture team functioned as an 'active professionalization' of the venture firm. However, with the indicative empirical data and arguments made that it is the feedback loop in the context of monitoring and controlling that serves the function of improving the internal reporting of the firm, and that the VC do not provide operational assistance in this matter, we find the naming and modeling of relationship (1) in figure 2 to be misrepresenting. Accordingly, we posit that:

> P1a: Monitoring and controlling passively professionalize the firm's standard of formal control systems and routines.
>
> P1b: Monitoring and controlling positively affects the firm's standard of formal control systems routines.

7.1.2 Relationship (2): Passive professionalization through recruiting

In two of the cases the VC hired a new CEO to run the company. In case 3, where this was not the situation, the CEO was also the founder with a diverse professional background and whom the VC had very high confidence to as a manager. Also, in the two largest exits (Odin and Frigg) measured in deal size, an external CFO was hired through the VC's network and the VCs also participated in the interviews of the candidate(s). These findings are consistent with previous research suggesting that VCs participate in recruiting activities and in particular to executive positions (Timmons & Bygrave 1986; Gorman & Sahlman 1989; Ehrlich 1994; Hellmann & Puri 2002). When the CEOs were asked how this contributed with regard to introducing and improving formal control systems and routines, the consensus was that the people in question (either themselves or the CFO) played an important, and in some cases an essential role in getting the formal structure in place. This is supported by several scholars (Greiner 1972; Daily & Dalton 1992; Greiner 1998) who find that experienced management with solid business skills bring with them their system of belief, business acumen and favors formal control mechanisms. However, no findings pointed in the direction that this was a proactive measure put in place by the VC with the intent of facilitating the liquidity event, i.e. the DD process, but an act with the intent of strengthening the company in different areas. In fact, both the Odin and Frigg VC participated in the hiring of the CFO linked the hiring to the expected growth and the internationalization of the company. In the company that did not hire a CFO, the VC's had underestimated the market size and potential growth opportunities and was not willing to commit any more capital to the cause, leading the CEO to do most of the accounting and reporting himself. Nonetheless, this does not undermine the premise that the VC passively contributes to professionalizing the firm through recruiting. In contrast, involvement in recruiting to executive positions serves as a utility in this context and represents a causal link to the professionalization, as also outlined by Hellmann & Puri (2002). Based on the empirical data and the arguments made, we put forward the following propositions:

> P2a: Recruiting passively professionalize the firm's standard of formal control systems and routines.
>
> P2b: Recruiting positively affects the firm's standard of formal control systems routines.

7.2 Research question 2

In research question 2 we asked how the VC's professionalizing may affect the trade sale with regard to the DD, if at all. In chapter 3, we outlined the risk reducing and risk inducing mechanisms of M&As, and developed a conceptual model (Figure) where the DD plays an important part as a risk reducing mechanism. Further, we developed an exploratory model (Figure 2) portraying how the VC might contribute in reducing the risk of a deal by professionalizing the firm, i.e. preparing the firm for the upcoming liquidity event and financial DD.

7.2.1 Relationship (3) & (4): (1) and (2)'s effect on the financial due diligence

Turning to the empirical world, when we asked the acquirers about the financial DD process, we got several interesting views which emphasize the importance they put on it, and also what might happen if everything is not in order. Both in the Thor case and the Frigg case, the acquirers experienced the financial DD as effective and they got all the information they needed at the quality they expected. Also, in these two cases, the executive management of the targets indicated that they had very good control of their internal reporting and accounting system and routines and that they were aware of the its importance in relation to the exit. The latter sentiment is in stark contrast to the VCs who indicated that they did not share the same view in preparing for the exit, stating that it was just normal procedure; explicitly not relating it to the exit but with the intent of building and monitoring their portfolio company. This may be explained by the notion that the executive management show a more operational approach to the issue - they are the ones in the line of firing when the numbers were put to the test in the financial DD, while the VC plays a more passive role in that setting; the VC's from our case companies mostly had a supervisory role in the sales process, but got more involved in the final negotiations. The acquirers affiliated with the Thor and Frigg cases indicated that they believe venture capital firms generally play an important role in preparing their investees for the exit and the DD since venture-backed firms live under a stricter regime with regard to reporting and that organically grown companies do not understand the value of fully audited financial reports. Further, both of them hypothesized that if the 'numbers did not add up', that would introduce risk and uncertainty to the deal, also pointing out that this might affect the price and buy-decision.

It seems like there is a conflicting view: The executive management take notice and is prepared for the financial DD, the acquirers put high importance on it while the VCs do not relate anything they contribute with to the issue. Linking this with the discussion from research question 1, we argue that the VCs have a less conscious view of the stress test their investees will be put to in a trade sale, and are more focused on monitoring and recruiting, and by those NFVA activities 'unintentionally' contribute in preparing the firms. This is somewhat surprising, since the liquidity event is a critical phase of the VC's investment and the financial DD is a prerequisite for the acquirer in this setting (Wall & Smith 1997). However, we speculate that the

VC simply anticipates this to be in order, e.g. by hiring professional management, and uses energy on more pressing matters, like strategizing and product and customer development.

The Odin case provides attestation to what might happen when the portfolio company lacks the ability to convey adequate information at par with the acquirer's expectation. During the financial DD, the acquirer found grave inadequacies which almost derailed the acquisition as it added time and cost to both parties. During the interviews, the authors got a sense that the CFO was not able to produce the numbers and models required, in addition, the Odin CEO indicated that some of numbers provided was not quality assured before being shipped. The situation caused a crisis of confidence during the deal, and raised questions in the acquirer's mind that led them to conduct a full audit. This caused the costs of the financial DD to increase significantly. Surprisingly, the full audit resulted in a better outcome than what the Odin target had first calculated; an indication of unrealized potential in the deal. The CFO was recruited through the Odin VC's network, but did not have a proper background as an accountant according to a secondary source. The shortcomings in the CFO's background, may lend itself as the cause for the hurdles experienced during the financial DD. However, the VC and the CEO blamed the complications on mistakes conducted during quality assurance of the information sent, and indicated a personality mismatch between the CFO and the acquirer. When we asked the acquirer whether the situation was reflected in the price, they indicated that it was not the case, but that it was reflected in the way the deal was structured with earn-outs. This indicates that the acquirer associated more risk with the deal, and put in place measure to mitigate it in accordance with figure 1. No matter what went wrong, where and who was the cause in this case, the acquirer's observations tells the tale about the important role the formal structure and routines of a firm have when the firm is to be put up for the test in the financial DD, and how this relates to the risk associated with the trade sale. The findings from our three cases are in line with Wall and Smith (1997) who stress the importance of providing adequate and precise information during the DD, which can only be done by having professional and expositive financial statements and reporting systems. We therefore put forward the following propositions:

> P3a: The more professional and structured the formal control systems of a firm, the more it positively affects the financial due diligence.

> P3b: The less hurdle in the financial due diligence, the less risk the acquirer associates with the deal.

Linking proposition 1a & 1b and 2a & 2b with propositions 3a & 3b can be argued to be a fallacy: if the VC's activities outlined in propositions 1 and 2 are not related to the exit, but are merely a day-to-day operational measure to 'build a great company' via monitoring and controlling and ensuring that the company has the resources it needs via recruiting, the 3rd posits that the VC's activities contribute to a professionalization of the firm and which ultimately have an effect in the financial DD, holds less validity. From the VC's perspective, the activities outlined in this paper can be viewed as a utility in attaining the perceived growth opportunities and prosperity of their investment - professionalization with the intent of performing well in a DD is not the VC's goal in itself. However, the objective of this paper was to explore what VC NFVA activities the acquirer values, and from this perspective, the professionalization of the firm's internal standards and routines of reporting, accounting and financial control are valuable since it reduces the risk and uncertainty associated with the acquisition. However unexplored in this paper, we expect that the activities outlined in research question one also creates value to the acquirer in many other ways, e.g. is it not far-fetched to speculate that recruiting play an indirect role in the growth or internationalization of the company, as indicated by two of the VCs, which presumably is valued by the acquirer in terms of market share and position. Based on the discussions and propositions put forward in this chapter, we present a refined model of Figure 2 in figure 3.

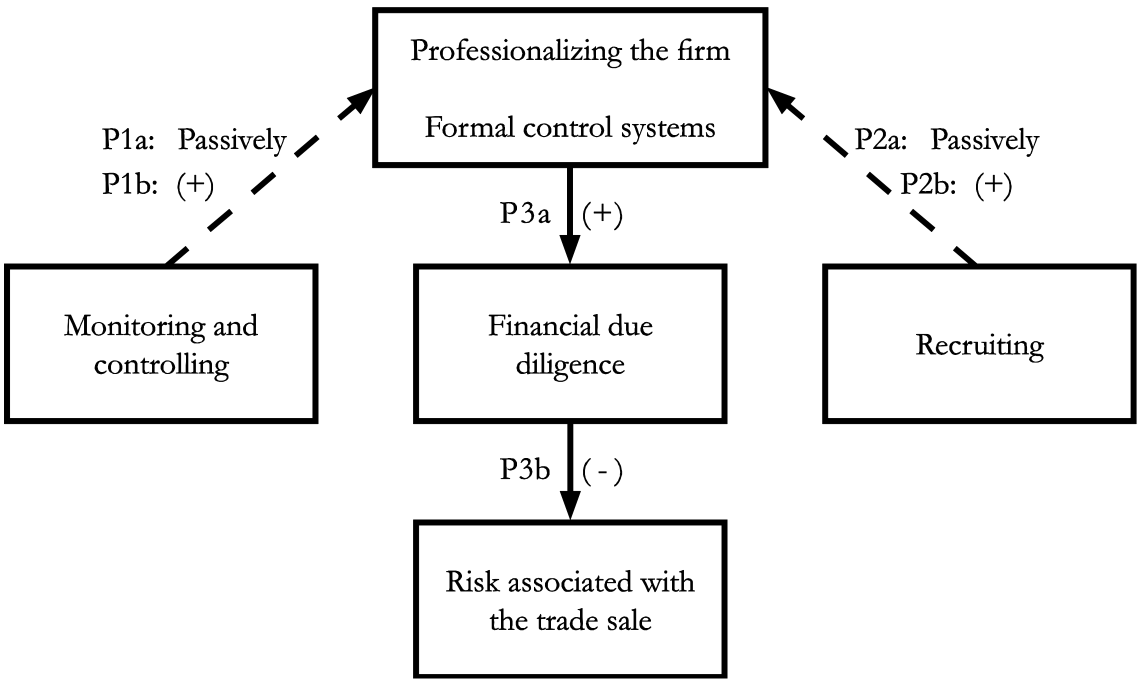

Figure 3: A refined exploratory model depicting the proposed relationships. The dashed arrows illustrate that the VC do not primarily engage in these activities with the intent of preparing the firm for the financial DD, but passively professionalize the firm in this setting. The (+) indicate that the activity has a positive effect, while the (-) illustrate a reduction in the associated risk with the trade sale.

8 Conclusions and implications

This paper set out with the goal of including the acquirer as a perspective on the VC's role in professionalizing the venture-backed firm with regard to formal control systems and routines and its effect in a trade sale, thereby exploring whether this could be viewed as a value-adding activity through the focal lens of the buyer. To our knowledge, this is the first paper exploring such activities from the triad consisting of the VC, the venture-backed company and the acquirer, pioneering a new method on approaching the complex question often debated in this context: whether and in what ways do venture capitalists add value to their portfolio firms?

Due to the importance of the financial DD in a trade sale, this paper therefore sought answers to the following research questions: (1) How do the VC contribute in professionalizing the venture-backed firm with regard to formal control systems and routines? (2) How, if at all, do professionalization with regard to formal control systems and routines affect the DD process of the trade sale?

Via a multiple-case study, covering 3 trade sales performed by Norwegian VCs, we have indicated that the VC 'unintentionally' prepares the firm for a financial DD by passively professionalizing formal control systems and routines through an operational focus on monitoring and controlling and by assisting in the recruitment of executive management. Additionally, we have indicated the existence of a link between these activities and a reduction of risk associated with the trade sale, since the total risk in the deal is reduced by conveying adequate and expositive information at par with the acquirer's expectancy in the financial DD. Conclusively, these are VC NFVA activities that are value-adding from the acquirer's perspective, even if they may be seen as mere operational activities from the VC's perspective. These propositions have only been possible to put forward due to the inclusion of the acquirer, validating our choice of methodology.

8.1 Implications for practitioners

Our results indicate that the VC should take steps in order to reduce any possibilities of disruptions or hurdles during the financial DD. Any sign of mistakes or inconsistency will make the acquirer scrutinize every aspect of the target firm, making the acquisition process longer and tougher than it needs to be. Moreover, these steps needs to be taken proactively since it may be too late if or when an acquirer considers to take out the wallet. Firstly, the VC should take a more conscious view of the importance the internal control systems and routines play in the liquidation event, primarily by conveying this sentiment towards the CEO or the CFO when they report on the business during e.g. board meetings. It is important for the VC to keep in mind that the entrepreneurial team might perceive formal control systems and routines as an annoyance and bureaucratic meddling on the part of the VC. Therefore, the VC should stress the importance of having formal control systems and routines of high quality when they are put to the test in the DD, instead of focusing on the VC's own reporting demands as the reason for implementing them. An incentive that might be conveyed to the management is that this increases the chances of a successful pay day and that high quality portrayed in 'the numbers' and 'the assumptions behind them', also communicates high quality of management; an important notion if the management is to join the acquiring company post-deal. Secondly, the VC should take careful considerations when recruiting the CFO, ensuring that he or she has the appropriate skills and experience required when taking on the challenge of working with growth firms lacking proper reporting and control systems.

8.2 Implication for future research

The authors appraise the primary implication to future research to be the relevance of including the acquirer when researching whether VCs add value to their portfolio firms or not, and what these activities are.

This paper studied VC NFVA effects on the financial DD. Based on the theoretical framework, data and discussion; we have forwarded several propositions with implications for future research. Firstly, we indicate that there is link between the VC's NFVA activities and state of internal reporting and control in the firm. Secondly, we indicate that this may affect the outcome of the financial DD in terms of buy decision and valuation. Considering the importance of the liquidity event in the venture capital business model, the prevalence of trade sales and the importance of the financial DD to the acquirer, these propositions should be operationalized with the intent of putting forward hypothesis testable in a quantitative research design. Albeit our efforts to deconstruct the relationships discussed, we reckon that future qualitative research should include a larger sample of cases which might unveil different or additional VC NFVA activities contributing to a smooth financial DD, not explored in this paper. Such a study could also include deals that were initiated but not consummated and acquisitions of organically grown companies.

Moreover, the financial DD is just one of many sub-analysis conducted in an acquisition, and it would be interesting to explore how the VC might contribute to facilitating the acquisition with regard to other units of analysis, such as organizational- and IT DD. It would also be interesting to explore how the outcome of these sub-analysis affects the structuring of the deal; in one of the cases included in this paper, the deal was structured as an earn-out due to disruptions during the financial DD. This may indicate that if the financial DD is not perceived to reduce the risk adequately, the risk is equilibrated to an acceptable level by employing other mechanisms, such as post-closing instruments.

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