AGJ ARABIAN GROUP OF JOURNALS

Social Development

NG-Journal of Social Development, VOL. 5, No. 3, June 2016

Journal homepage: www.arabianjbmr.com/NGJSD_index.php

NG-Journal of Social Development NGJSD Arabian Group of Journals

VENTURE CAPITAL AS A SOURCE OF FUND FOR ENTREPRENEURS

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Abstract

The paper agreed with evidence that angel-funded startup companies are less likely to fail than companies that rely on other forms of initial financing. When a venture approaches the venture capitalist firms, the venture is going to do more than negotiating about the financial terms. Apart from the financial resources these firms are offering; the Venture Capitalist-firm also provides potential expertise the venture is lacking, such as legal or marketing knowledge. The exist procedure of a deal was found to be an important consideration for both the entrepreneur and the venture capitalist. Exits can take several forms and can be spread out over several years, based on the structure of each deal and the performance of the venture company. At the outset each deal is considered on the basis, that in 4 to 7 years there will be an Initial Public Offering (IPO) or strategic purchase of the company by a third party. These are generally the preferred exit methods, since they usually offer the highest rate of return. Therefore, we concluded that the positive impact of venture capital is indeed driven by the funding and managerial support provided by venture capitalists.

Key Words: Venture Capital, Entrepreneurship, Business Angel, Exit Procedures, Growth Companies

Introduction

Nature of Venture Capital

Venture capital is one of the least understood areas of entrepreneurship. Some think that venture capitalists do the early–stage financing of relatively small, rapidly growing technology companies. It is better to view venture capital broadly as a professionally managed pool of equity capital. Frequently, the equity pool is formed from resources of wealthy partners. Other principal investors in venture-capital companies are pension funds, endowment funds, and other institutional investors. Some known sources of venture capital in Nigeria include CBN/Banker's Committee Small & Medium Equity Investment Scheme, BTA Foundation for Agriculture, Faith Foundation, Micro-Finance Fund Initiatives and more recently CAP fund from Bank of Industry.. The investments are in early-stage deals as well as second and third-stage.

What is a Venture Capital

Venture capital is funds invested or available for investment in potentially highly profitable enterprises at considerable risk of loss. Venture capital is often used interchangeably with other terms such as risk capital, patient capital or equity financing. Venture capitalists are companies or individuals who provide investment capital, management expertise and experience. In return for their investment, venture capitalists will take an equity position in the company, usually in proportion to the amount of their investment and the level of risk involved. The future return on their investment is tied to the performance of your company.

Venture capital is a typically longer term (4 to 7 years) investment that often takes a venture firm through more than one business cycle. They take equity position in the company that does not require regular payment. Venture capitalists look for a capital gain and an increase in the value of their shares. The company's future and the venture capitalists future are integrally linked. Venture financiers are partners, not lenders. The success of the venture firm is their goal. As an investor-partner, the venture capitalist will take part in the management of the venture company, through its Board of Directors participation.

Since the seminal work by Jaffee and Russell (1976) and Stiglitz and Weiss (1981), the argument that there are frictions in capital markets that make it difficult for firms to obtain external financing and constrain their investment decisions has increasingly been gaining ground in the economic and financial literature (Fazzari *et al.* 1988 and the studies mentioned by Hubbard 1998). New technology-based firms (Small and rapid growth companies) are those most likely to suffer from these capital market imperfections. In turn, the fact that poor access to external financing may limit the growth and even threaten the survival of Small and rapid growth companies is worrisome because of the key role these firms play in assuring dynamic efficiency and employment growth in the economic system (Audretsch 1995, Acs 2004).

The above arguments especially apply to bank loans (Carpenter and Petersen 2002). In fact, banks generally do not possess the competencies required to evaluate *ex ante* and monitor *ex post* the investment projects proposed by young high-tech firms that lack a track record. In principle, the above mentioned adverse selection and moral hazard problems can be alleviated through the recourse to collateralized loans (Berger and Udell 1998). Nonetheless most of high-tech investments are in intangible and/or firm-specific assets that provide little collateral value.

Venture capital financing is generally considered by both academics and practitioners as a more suitable financing mode for Small and rapid growth companies than bank loans. In fact, it is contended in the financial literature that this financing mode offers a fundamental contribution to the success of high-tech entrepreneurial ventures (Sahlman 1990, Gompers and Lerner 2001, Kaplan and Strömberg 2001, Denis 2004).

Nonetheless, whether access to venture capitalist financing spurs the growth of portfolio companies is a matter of empirical test. The results of previous studies on this issue are not unanimous. The reason may be that these studies suffer from several methodological weaknesses. First, most of them analyze samples of firms that eventually went public. These samples are not representative of the small and rapid growth companies population, since privately held firms are not considered. Moreover, they capture the moderating effect of venture capitalist financing on the relationship between the IPO and firm growth rather than the direct effect of venture capitalist financing on growth. Second, most studies resort to cross-sectional estimates and, consequently, their results are likely to be biased as they do not manage to properly control for unobserved heterogeneity across firms and reverse causality. Quite surprisingly, studies based on longitudinal datasets are rare (Davila *etal.* 2003, Alemany and Marti 2005). Lastly, it has recently been argued in the venture capitalist literature that there is great heterogeneity across venture capitalist investors, especially in Europe (Tykvova 2007, Bottazzi *et al.* 2004).

Therefore the effect of venture capitalist financing on the growth of portfolio firms may well be contingent on the characteristics of the investor (Tykvova and Walz 2007, Engel and Heger 2006).

Literature review

The financial literature highlights several motives explaining why access to venture capitalist financing propels the growth of Small and rapid growth companies. First of all, venture capitalist investors generally focus on specific industries (see among others Gompers 1995, Amit *et al.* 1998, Bottazzi and Da Rin 2002). Due to their sectoral specialization, they allegedly develop context-specific screening capabilities that make them able to judge quite accurately the commercial value of entrepreneurial projects and the entrepreneurial talent of the proponents (Chan 1983, Amit *et al.* 1998.) Therefore, they are able to deal effectively with the adverse selection problems that would otherwise prevent great hidden value firms from obtaining the financing they need. In turn, relaxation of financial constraints leads to higher firm growth.

Second, venture capitalist firms are no silent partners (Gorman and Sahlman 1989, Barry *et al.* 1990*)*. On the one hand, they actively monitor portfolio companies. For instance, Kaplan and Strömberg (2003) show that venture capitalist firm's control 41.4% of the seats of the board of directors of the US venture capitalist-backed companies that are considered in their study; in 25% of the companies they control the majority of the board seats. Bottazzi *et al.* (2004) document that in 66% of the deals of European venture capitalist firms the venture capitalist investor obtained one or more seats of the board of the participated company. Moreover Lerner (1995) highlights that the number of venture capitalist investors who sit in the board of directors is more likely to increase between two financing rounds if during the same period the top manager of the participated firm is replaced, that is in situations where monitoring is most important.

On the other hand, venture capitalist investors make use of specific financial instruments and contractual clauses (e.g. stage financing) that protect their investments from opportunistic behavior on the part of entrepreneurs and create high powered incentives for them (Sahlman 1990, Gompers 1995, Hellmann 1998, Kaplan and Strömberg 2003, 2004).

Third, venture capitalist investors allegedly perform a key coaching function to the benefit of portfolio firms (Gorman and Sahlman 1989, MacMillan *et al.* 1989, Bygrave and Timmons 1992, Sapienza 1992, Barney *et al.* 1996, Sapienza *et al*. 1996, Kaplan and Strömberg 2004).In fact, they provide advising services to portfolio companies in fields such as strategic planning, marketing, finance and accounting, and human resource management, in which these firms typically lack internal competencies. Accordingly, Hellmann and Puri (2002) document that venture capitalist investor's favor the recruitment of external managers, the adoption of stock option plans, and the revision of human resource policies by portfolio firms, thus contributing to their managerial "professionalization". Bottazzi *et al.* (2004) show that European venture capitalist firms helped portfolio companies in recruiting outside directors and senior managers in 40.8% and 48.4% of the deals they analyze, respectively. Moreover, portfolio companies take advantage of the network of social contacts of venture capitalist investors with potential customers, suppliers, alliance partners, and providers of specialized services like legal, accounting, head hunting, and public relation services (Lindsey 2002, Colombo *et al.* 2006, Hsu 2006).

Lastly, venture capitalist financing signals the good quality of small and growth companies to third parties; therefore venture capitalist-backed companies find it easier to get access to external resources and competencies that would be out of reach without the endorsement of the venture capitalist (Stuart *et al.* 1999). In accordance with the existence of a "certification effect", Megginson and Weiss (1991) find that US venture capitalist-backed IPOs exhibit smaller underpricing than non venture capitalist backed ones that are matched by sector and IPO size. Nonetheless, it is important to acknowledge that the agency relation between the venture capitalist investor and the entrepreneurs of portfolio companies may engender conflicts, leading to a deterioration of the performance of these latter companies. In fact, entrepreneurs and external investors may have different strategic visions; disagreements may absorb the entrepreneurs' effort and attention to the detriment of the pursuit of business opportunities. Even if no conflict arises, the need of venture capitalist investors to monitor managerial decisions may increase bureaucracy and formalization of decision processes, hampering flexibility and the ability of firms to timely grasp business opportunities. Furthermore, as venture capitalist investors are competent investors, they might be able to expropriate entrepreneurs of their innovative business ideas and exploit them.

THE ENTREPRENEURIAL CLIMATE

The classic empirical result on growth or the absence of it, for which Robert Solow received the 1987 Nobel Prize in Economics, is that technological progress accounts for about half of the growth in per capita output. Most of the growth slowdown (in per capita income) can be traced to a slowdown in productivity growth. Another possibility is a slowdown in the rate of production of relevant knowledge, a decline in the rate of increase of the skills of labour, a decline in the rate of investment

Broadly based education, however, is just one element of an environment that fosters entrepreneurs. Another closely related one is the availability of a pool of talent and knowledge, which implies that there must be not only a good general education but education in science, engineering, and the various skills of business. A large fund of scientific and technical knowledge must also be available for potential entrepreneurs to draw on, which means active research in science by academic institutions, business, and government. To be successful, venture capitalists must have a broad general knowledge of business and all its disciplines: marketing, management, finance, operations, accounting, and so on. In addition, most venture capitalists must acquire specialized knowledge in one or more high technology industries.

Another element is a moderate tax rate for businesses and individuals so that money earned can be kept and capital built. Venture capital is also vital to fostering the founding and growth of new businesses, providing not only money to young businesses but sophisticated help and advice. commercial banks willing to lend to smaller businesses are also vital for short-term finance. An active investment banking sector, coupled with public stock markets, gives successful, growing companies access to large amounts of capital and entrepreneurs and their investors a pathway to liquidity. Underlying all these elements is a system of laws and courts to establish and protect private property and contracts, create workable business entities, protect competition, and provide bankruptcy procedures for companies who fail. One final element is a broad acceptance of the fact that entrepreneurs are engaged in an activity that is admirable and vital to the success and growth of a country.

The added value of venture capitalist financing

A venture capitalist-firm is not only about funding and lucrative returns, but it offers also the non-funding issues like knowledge as well as for internal as for external issues. Also what we see here the further the process goes, the less risk of losing investment the venture capitalist-firm is risking. Venture capital plays an increasingly important role in the financial system and the economy. Providers of venture capital attempt to identify firms, typically in early or developmental stages, which possess strong potential for profitable growth. Like any providers of finance, venture capitalists monitor the performance of the firms they fund, including prospective involvement in the management and/or governance of said firms. Once the underlying business has sufficiently developed, the venture capitalist typically cashes out its investment and diverts funds to new opportunities. To exit the firm, the venture capitalist can sell its entire stake to another venture capitalist or another company or, in the event of failure, liquidate assets. However, the preferred exit strategy is to take the firm public in an initial public offering (IPO), thereby creating a market for the equity owned by the venture capitalist (e.g. Barry et al., 1990; Das et al., 2003). We focus on this specific segment of venture capital financings: those that culminate in an initial public offering.

We concentrate on the IPO process in order to analyse the potential certification role that venture capitalists play in facilitating an equity offering. Venture capitalists expend significant resources in screening firms and presumably invest only in those perceived to be of the highest quality. In addition, those companies that evolve to the IPO stage represent the most successful of the set of firms funded with venture capital. Understanding the potential impact of certification is important for investors seeking to identify optimal candidates for investment, as well as for managers searching for the 'best' venture capitalist.

The literature addressing the influence of venture capitalists on the IPO process is extensive, but focuses primarily on whether or not an IPO is backed by any venture capitalist, implicitly assuming that all venture capitalists are alike. One exception to this general approach is Gompers and Lerner (1999), who address differences between IPO firms where the venture capitalist is affiliated with an investment bank versus those that are not.

While there has been a growth in interest in business angels by both academics and policy makers in recent years, there are still areas of their activities that remain under researched. One of the most significant of these is the angel investment process. The objective of this exploratory study is to add to the relatively limited literature by setting out an empirically based model of the angel investing process. In particular, it addresses the calls by Haines et al. (2003) and Feeney et al. (1999) to better understand the investment decisions of business angels and to examine the factors impacting upon different stages of the investment process. Haines et al. (2003) also suggested further consideration of the link between formal and informal investors and this is addressed by highlighting similarities and differences between the findings of the current research and what we know about the formal venture capital market.

A soundly based and readily understood model offers a number of advantages to stakeholders in the investment process. It can help entrepreneurs and angels better appreciate the concerns that each party to a deal may have as well as providing insight into the complexities associated with reaching an agreement. It may also be useful to prospective business angels by highlighting the key activities that need to be managed effectively for successful outcomes. Furthermore, a clearer understanding will enable policy makers and support agencies direct initiatives at different stages of the investment process rather than adopting 'blanket' solutions to market imperfections (Westhead and Wright, 1998).

There are lots of hotels and restaurants in Nigeria. Any Entrepreneur that can come up with a technology that will create efficiency, maybe a 10 per cent reduction in diesel or gas usage, venture capitalists will jump on that because these hotels use a lot of energy. This is the essence of innovation.

The Business Angel Investment Process

Angels in Venture Capital Market are specific type of Venture Capitalists. They are individuals in a community who invest in local businesses, less formal and less public in their approach to investing. The literature on the business angel investment process is limited in scope and detail. Attempts that examine the overall process include Amatucci and Sohl (2004), Haines et al. (2003) and Van Osnabrugge and Robinson (2000). Amatucci and Sohl (2004) divided the process into three broad stages, namely pre-investment, contract negotiation and post-investment, to facilitate their study of women entrepreneurs. Haines et al. (2003) offered a more elaborate eight-stage model for their focus group interviews with Canada-based angels, but cautioned against concluding that it represented the process that informal investors use. Van Osnabrugge and Robinson (2000) also applied a generalized eight-stage framework to both venture capitalists and business angels but, again, this lacked an empirical basis.

The majority of studies of the informal investment process have generally taken a disaggregated approach and focused on particular stages from a supply-side perspective. For example, in screening investments Fiet (1995a, b) has highlighted the importance of agency risk to business angels while Madill et al. (2005) have found that angels are likely to consider how they can contribute to the business over and above their financial contribution. Feeney et al. (1999) and Mason and Harrison (1996) focused on the decision stage of the investment process by examining the evaluation criteria of business angels, finding that considerable weight is given to the assessment of the entrepreneur's abilities and track record. In reaching a decision a key issue for an angel is the balancing of risk and reward. How likely is it that the actual outcomes of the investment will be different from that predicted, and how does this risk compare with the potential returns from the business? A constructive view of decision making (Payne et al., 1992) suggests that an angel will be faced with a choice characterized by conflict, uncertainty and complexity. Conflict may arise over the finer points of the agreement. Uncertainty may surface, for example, where nagging doubts persist about the ability of the entrepreneur behind the business.

Complexity may be increased where an angel has been considering more than one investment opportunity or participates in an investment syndicate whose members have differing views as to the commercial viability of the entrepreneur's plans. The angel's assessment of the personal qualities and characteristics of the entrepreneur becomes very important.

Venture Capital Financing Process

As written in the previous paragraph, there are several ways to attract funding. However in general, the venture capital financing process can be distinguished into five stages;

1. The Seed stage
2. The Start-up stage
3. The Second stage
4. The Third stage

5. The Bridge/Pre-public stage

The Seed Stage

This is where the seed funding takes place. It is considered as the setup stage where a person or a venture approaches an angel investor or and investor in a venture capitalist-firm for funding for their idea/product. During this stage, the person or venture has to convince the investor why the idea/product is worth to invest in. The investor will investigate into the technical and the economical feasibility (Feasibility Study) of the idea. In some cases, there is some sort of prototype of the idea/product that is not fully developed or tested.

If the idea is not feasible at this stage, and the investor does not see any potential in the idea/product, the investor will not consider financing the idea. However if the idea/product is not directly feasible, but part of the idea is worth for more investigation, the investor may invest some time and money in it for further investigation.

The Start-up Stage

If the idea/product is qualified for further investigation and/or investment, the process will go to the second stage; this is also called the start-up stage. At this point many exciting things happen. A business plan is presented by the attendant of the venture to the venture capitalist-firm. A management team is being formed to run the venture. If the company has a board of directors, a person from the venture capitalist-firms will take seats at the board of directors.

While the organization is being set up, the idea/product gets its form. The prototype is being developed and fully tested. In some cases, clients are being attracted for initial sales. The management-team establishes a feasible production line to produce the product. The venture capitalist-firm monitors the feasibility of the product and the capability of the management-team from the Board of directors.

To prove that the assumptions of the investors are correct about the investment, the venture capitalist-firm wants to see result of market research to see whether the market size is big enough, if there are enough consumers to buy their product. They also want to create a realistic forecast of the investment needed to push the venture into the next stage. If at this stage, the venture capitalist-firm is not satisfied about the progress or result from market research, the venture capitalist-firm may stop their funding and the venture will have to search for another investor(s). When the cause relies on handling of the management in charge, they will recommend replacing (parts of) the management team.

The Second Stage

At this stage, we presume that the idea has been transformed into a product and is being produced and sold. This is the first encounter with the rest of the market, the competitors. The venture is trying to squeeze between the rest and it tries to get some market share from the competitors. This is one of the main goals at this stage. Another important point is the cost. The venture is trying to minimize their losses in order to reach the break-even.

The management-team has to handle very decisively. The venture capitalist-firm monitors the management capability of the team. This consists of how the management-team manages the development process of the product and how they react to competition.

If at this stage the management-team is proven their capability of standing hold against the competition, the venture capitalist-firm will probably give a go for the next stage. However, if the management team lacks in managing the company or does not succeed in competing with the competitors, the venture capitalist-firm may suggest for restructuring of the management team and extend the stage by redoing the stage again. In case the venture is doing tremendously bad whether it is caused by the management team or from competition, the venture will cut the funding.

The Third Stage

This stage is seen as the expansion/maturity phase of the previous stage. The venture tries to expand the market share they gained in the previous stage. This can be done by selling more amount of the product and having a good marketing campaign. Also, the venture will have to see whether it is possible to cut down their production cost or restructure the internal process. This can become more visible by doing a SWOT analysis. It is used to figure out the strength, weakness, opportunity and the threat the venture is facing and how to deal with it.

Except that the venture is expanding, the venture also starts investigate in follow-up products and services. In some cases, the venture also investigates how to expand the life-cycle of the existing product/service.

At this stage the venture capitalist-firm monitors the objectives already mentioned in the second stage and also the new objective mentioned at this stage. The venture capitalist-firm will evaluate if the management-team has made the expected reduction cost. They also want to know how the venture competes against the competitors. The new developed follow-up product will be evaluated to see if there is any potential.

The Bridge/Pre-public Stage

In general this stage is the last stage of the venture capital financing process. The main goal of this stage is to achieve an exit vehicle for the investors and for the venture to go public. At this stage the venture achieves a certain amount of the market share. This gives the venture some opportunities like for example: hostile take over, merger with other companies, keeping away new competitors from approaching the market and eliminate competitors.

Internally, the venture has to reposition the product and see where the product is positioned and if it is possible to attract new Market segmentation. This is also the phase to introduce the follow-up product/services to attract new clients and markets.

As we already mentioned, this is the final stage of the process. But most of the time, there will be an additional continuation stage involved between the third stage and the Bridge/pre-public stage. However there are limited circumstances known where investors made a very successful initial market impact might be able to move from the third stage directly to the exit stage. Most of the time the venture fails to achieves some of the important benchmarks the Venture Capitalist-firms aimed.

As mentioned in the first paragraph, a venture capitalist-firm is not only about funding and lucrative returns, but it offers also the non-funding issues like knowledge as well as for internal as for external issues. Also what we see here the further the process goes, the less risk of losing investment the venture capitalist-firm is risking.

Research

It is important to select the Venture Capitalist that is right for you. The more people who know about your project and its requirements, the better your chances to locate funding. Accountants, Bankers and lawyers are good sources of referrals and will usually provide introductions for you.

Presenting the Plan

You should provide the Executive Summary of your plan to all parties before the initial meeting. The Venture Capitalist is interested in the history of your company and the background of the management team. Emphasize the strengths of the proposal, and remember the goal of the Venture Capitalist. Show them how they can make money and how they can help you grow.

Due Diligence

A willing Venture Capitalist will begin conducting some preliminary due diligence of your company. This means looking into all aspects of your company, its management, product, market and competition. You will then most likely be presented with a spread sheet detailing the proposed amounts, form (common or preferred shares, sub-debt), valuation and the terms and conditions of the investment. Once agreement has been reached, the Venture Capitalist will then undertake full due diligence.

The Process - Timing

Once you have selected a Venture Capitalist you feel is right for you, it is important to recognize that the process takes time. As you will be partners for an average of 4 to 7 years. It is in your best interest to devote the time required to forge a good relationship, treating the investor as a partner not merely as a source of funds.

Exist Strategies

Exits can take several forms and can be spread out over several years, based on the structure of each deal and the performance of your company. At the outset each deal is considered on the basis that in 4 to 7 years there will be an Initial Public Offering (IPO) or strategic purchase of the company by a third party. These are generally the preferred exit methods, since they usually offer the highest rate of return.

Other exiting methods include: management buyout, sale or merger of company, corporate redemption, forced receivership, sale of shares to principals and sale of shares to other equity partners

Conclusions

Venture capitalists are different from other financial intermediaries in that they provide governance and value added to the companies they invest in The interaction of money plus value added is supposed to create value in the venture companies. As a result, it is assumed that there is a positive impact of venture capital funding on the economy.

The study of the impact of venture capital funding on the economy is important for investors, venture capital organizations and government authorities essentially due to its employment growth potentials. There are several implications of these results. First, venture capital is a suitable tool to foster economic growth since funded companies at different stages, with and without a technological base, outperform similar non- venture capital -backed companies. Second, the combination of funding plus value added venture capital improves the growth patterns of venture companies.

Venture capital investment offers greater opportunities for both huge gains and terrible losses.

This is similar to a bank, because just as a bank takes money from depositors and then loans it to businesses and individuals, a Venture capital fund takes money from its investors and makes equity investments in portfolio companies.

The absence of political will on the part of government, coupled with the absence of concrete policies to encourage the entrepreneurial spirit in the private sector, has left us without any meaningful advances in technology. Nigeria has not quite fully embraced entrepreneurship as a key factor in modern production dynamics.

Entrepreneurs will form companies if permitted and protected by the legal system. Other conditions foster entrepreneurial growth and governments can play a role in establishing those conditions. By being able to exercise their economic freedom, entrepreneurs reinforce political and personal freedoms and are an important force in establishing and maintaining an open democracy. Entrepreneurs are the revolutionaries of our era.

Recommendations

We recommend the revivals and the revigoration of the moribund Small and Medium Equity Investment Scheme in Nigeria by the Central Bank of Nigeria/Banker's Committee. It will lead to the establishment and sustenance of venture capital companies as a vehicle to its implementation. The exit procedures adopted mostly by venture capital companies via initial public offering of shares will lead to the development of our Nigerian Capital Market particularly introducing small and medium indigenous enterprises unto the Nigerian second tie securities market.

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