

Entrepreneurial and Financial Studies

Hrsg.: Prof. Dr. Dr. Ann-Kristin Achleitner
Prof. Dr. Christoph Kaserer

Christian H. Fingerle

**Smart Money –
Influence of Venture Capitalists
on High Potential Companies**

Verlag Wissenschaft & Praxis



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Entrepreneurial and Financial Studies

Herausgegeben von

Prof. Dr. Dr. Ann-Kristin Achleitner

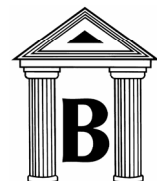
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Foreword

Across the globe, policymakers stress the importance of vibrant entrepreneurial activities in order to spur economic growth and innovation. Venture capitalists are commonly believed to contribute significantly to the rapid development of entrepreneurial firms. With the venture capital boom at the turn of the millennium being past, a sober assessment of the role of venture capitalists in the entrepreneurial process is now warranted.

Christian H. Fingerle provides a comprehensive analysis of the influence of venture capitalists on their portfolio companies. He explores the areas of potential value-added and discusses adjacent topics such as the extent to which entrepreneurs give up part of their managerial autonomy. The theoretical core of the study is greatly enriched by the presentation and comparative analysis of three unique case studies on German venture capital-backed companies.

I strongly believe that this work offers many valuable contributions for the venture capital industry and helps further professionalizing the entrepreneurial community. I am sure that it will find the broad audience it merits and will spark intensive discussions among scholars and practitioners.

Munich, 1 June 2005

Prof. Dr. Dr. Ann-Kristin Achleitner

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- Dr. Christian Friedemann and Dr. Karl-Heinz Pettinger (Bullith Batteries AG),
- Günther Baierl (varetis AG) and Dr. Konstantin Becker,
- Dr. Helmut Schühsler (Techno Venture Management),
- Dr. Michael Steinmetz (MPM Capital),
- Dr. Jürgen Diegruber and Tim Stemmer (Gi Ventures AG), as well as
- Dr. Wolf-Rüdiger Willig (Bayerische Beteiligungsgesellschaft mbH).

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Munich, 1 June 2005

Dr. Christian H. Fingerle

Table of Contents

Table of Figures.....	XV
Table of Abbreviations.....	XIX
Table of Interview Partners.....	XXI
1 Introduction	1
1.1 Relevance of Smart Money	1
1.2 Aims of Analysis	4
1.3 Research Approach and Dataset	6
1.4 Structure of Analysis	10
2 Characteristics of High Potential Companies.....	13
2.1 Introductory Remarks	13
2.2 Fundamentals of the Resource-based View.....	13
2.2.1 Resources in Strategic Management Research	13
2.2.2 Resources and Competitive Advantage.....	17
2.2.3 A Comprehensive Resource-based View	19
2.3 Resource Profile of High Potential Companies.....	24
2.3.1 Resource Needs in Stage Models	24
2.3.2 Resource Categorization	26
2.3.3 Technological Resources.....	27
2.3.4 Financial Resources.....	28
2.3.5 Managerial Resources	31
2.3.6 Personnel Resources.....	33
2.3.7 Physical Resources	34
2.3.8 Organizational Resources.....	34
2.3.9 Reputational Resources	35
2.3.10 Social Resources.....	37
2.4 Mechanisms to Fill the Resource Gap.....	38

2.5	Return and Risks of Investments in High Potential Companies	39
2.5.1	Investment Decision Trade-Off	39
2.5.2	High Expected Return	40
2.5.3	High Risks	44
2.5.3.1	Liability of Newness	44
2.5.3.2	Liability of Smallness	45
2.5.3.3	Uncertainty of Supply	45
2.5.3.4	Uncertainty of Demand	46
2.5.3.5	Competitive Uncertainty	47
2.5.3.6	Dependency on Founders	47
3	Business Model of Venture Capital Firms	49
3.1	Introductory Remarks	49
3.2	Definition of Business Model Concept	49
3.3	Customers of Venture Capital Firms	51
3.4	Value Creation Architecture of Venture Capital Firms	54
3.4.1	Organizational Structure	54
3.4.2	Personnel Structure	59
3.4.3	Refinancing Process	62
3.4.3.1	Overview	62
3.4.3.2	Fundraising Process	63
3.4.3.3	Investor Relations Process	66
3.4.3.4	Distribution of Returns Process	68
3.4.4	Investment Process	69
3.4.4.1	Overview	69
3.4.4.2	Investment Origination	70
3.4.4.3	Investment Due Diligence	73
3.4.4.4	Investment Structuring	77
3.4.4.5	Investment Development	81
3.4.4.6	Investment Exit	82
3.5	Customer Value Proposition of Venture Capital Firms	87
3.5.1	Enhancement of Performance of Portfolio Companies	87
3.5.2	Enhancement of Asset Allocation of Investors	90

3.6	Profit Model of Venture Capital Firms.....	99
3.6.1	Management Fee	99
3.6.2	Participation in Value Creation	100
4	Venture Capitalists' Influence through Contractual Agreements	103
4.1	Introductory Remarks	103
4.2	Deal-specific Risks for Venture Capital Firms.....	103
4.2.1	Risk of False Investment Decision.....	103
4.2.2	Risk of Managerial Opportunism.....	104
4.2.3	Risk of Competitive Opportunism	107
4.2.4	Risk of Unfavorable Decision-Taking	108
4.2.5	Risk of Exit Obstruction.....	109
4.3	Influence through Contractual Provisions	110
4.3.1	Information Rights	110
4.3.2	Conversion Rights	111
4.3.3	Control Rights	113
4.3.3.1	Voting Rights	113
4.3.3.2	Veto Rights	114
4.3.3.3	Supervisory Board Representation Right	115
4.3.4	Management Covenants	117
4.3.4.1	Affirmative Covenants.....	117
4.3.4.2	Non-Compete Clause	118
4.3.4.3	Vesting	119
4.3.4.4	Representations and Warranties.....	120
4.3.5	Milestone Agreements.....	121
4.3.5.1	Milestones	121
4.3.5.2	Earn-out.....	122
4.3.5.3	Ratchets.....	123
4.3.5.4	Management Dismissal	123
4.3.5.5	Staging	124
4.3.6	Cash Flow Rights	126
4.3.6.1	Dividend Preference.....	126
4.3.6.2	Liquidation Preference.....	127
4.3.6.3	Anti-Dilution Protection	128

4.3.7	Preemptive Rights	130
4.3.7.1	Right of First Refusal.....	130
4.3.7.2	Right of First Offer	131
4.3.8	Disinvestment Rights	132
4.3.8.1	Tag-Along Right.....	132
4.3.8.2	Drag-Along Right.....	133
4.3.8.3	Redemption Right.....	133
4.3.8.4	Registration Rights	134
4.3.8.5	Cancellation Right	135
4.3.9	Summary	137
4.4	Loss of Formal Autonomy through Venture Capital Firms	138
5	Venture Capitalists' Influence through Provision of Resources	141
5.1	Introductory Remarks	141
5.2	Content of Resource Provision.....	141
5.2.1	Activities of Venture Capital Firms	141
5.2.2	Certification through Venture Capital Firms	144
5.2.3	Resource-Based View on Activities of Venture Capital Firms	145
5.2.3.1	Redefining Activities as Resources	145
5.2.3.2	Direct vs. Indirect Resource Provision	147
5.3	Determinants of Resource Provision.....	148
5.3.1	Differences in Intensity of Resource Provision	148
5.3.2	Size of Investment.....	151
5.3.3	Performance of Portfolio Company	153
5.3.4	Stage of Portfolio Company.....	156
5.3.5	Technology Intensity of Portfolio Company	156
5.3.6	Venture Capitalists' Incentives for Resource Provision	157
5.3.7	Syndication.....	158
5.4	Loss of Real Autonomy through Venture Capital Firms	159
5.4.1	Sources of Venture Capital Firm's Power	159
5.4.2	Loss of Real Autonomy by Levels of Management	160
5.4.3	Loss of Real Autonomy by Levels of Decision-taking.....	164
5.4.4	Benefit of a Loss of Autonomy.....	167

6	Case Study Bullith Batteries AG.....	169
6.1	Case Description.....	169
6.1.1	Preliminary Remark	169
6.1.2	Development before First Round Financing	169
6.1.3	First Round Financing	174
6.1.4	Further Development until Second Round Financing.....	176
6.1.5	Second Round Financing	184
6.1.6	Further Development.....	186
6.2	Case Analysis.....	187
6.2.1	Gi Ventures' Influence through Contracting.....	187
6.2.1.1	Investment Agreement Structure	187
6.2.1.2	Influence on Deal-specific Risks	191
6.2.1.3	Influence on Management's Formal Autonomy	192
6.2.2	Gi Ventures' Influence through Resource Provision	193
6.2.2.1	Influence on Resource Pool	193
6.2.2.2	Influence on Management's Real Autonomy	197
7	Case Study GPC Biotech AG	201
7.1	Case Description.....	201
7.1.1	Development before First Round Financing	201
7.1.2	First Round Financing	203
7.1.3	Development until Second Round Financing	206
7.1.4	Second Round Financing	213
7.1.5	Further Development and MPM Capital's and TVM's Exit.....	215
7.2	Case Analysis.....	219
7.2.1	MPM Capital's and TVM's Influence through Contracting.....	219
7.2.1.1	Preliminary Remark	219
7.2.1.2	Investment Agreement Structure	219
7.2.1.3	Influence on Deal-specific Risks	223
7.2.1.4	Influence on Management's Formal Autonomy	224
7.2.2	MPM Capital's and TVM's Influence through Resource Provision.....	226
7.2.2.1	Influence on Resource Pool	226
7.2.2.2	Influence on Management's Real Autonomy	230

8	Case Study varetis AG	235
8.1	Case Description.....	235
8.1.1	Development before First Round Financing.....	235
8.1.2	First Round Financing.....	238
8.1.3	Development until Second Round Financing	241
8.1.4	Second Round Financing	245
8.1.5	Further Development and BayBG's Exit.....	247
8.2	Case Analysis	251
8.2.1	BayBG's Influence through Contracting	251
8.2.1.1	Investment Agreement Structure	251
8.2.1.2	Influence on Deal-specific Risks	256
8.2.1.3	Influence on Management's Formal Autonomy.....	258
8.2.2	BayBG's Influence through Resource Provision.....	259
8.2.2.1	Influence on Resource Pool.....	259
8.2.2.2	Influence on Management's Real Autonomy.....	263
9	Comparative Case Study Analysis.....	267
9.1	Venture Capitalists' Influence through Contractual Agreements	267
9.1.1	Contracting Negotiations	267
9.1.2	Content of Investment Agreements.....	268
9.1.3	Portfolio Companies' Loss of Formal Autonomy	269
9.2	Venture Capitalists' Influence through Resource Provision	271
9.2.1	Direct Resource Provision	271
9.2.2	Indirect Resource Provision	274
9.2.3	Dynamic Aspects of Resource Provision.....	278
9.2.4	Venture Capitalists' Influence on Competitive Advantage	279
9.2.5	Portfolio Companies' Loss of Real Autonomy.....	281
10	Conclusion and Further Implications	285
10.1	Conclusion.....	285
10.2	Implications for Researchers and Practitioners	288
11	References	293

Table of Figures

Figure 1: Structure of analysis.....	12
Figure 2: Interrelation between strategic management research streams.....	17
Figure 3: Comprehensive resource-based view of the firm.....	23
Figure 4: Resource needs in stage models.....	25
Figure 5: Ten largest European venture capital deals (2Q03-1Q04).....	29
Figure 6: Distribution of degrees of academic founders in Germany	32
Figure 7: Professional background of founders.....	33
Figure 8: Mechanisms to fill the resource gap of high potential companies.....	39
Figure 9: Investment decision trade-off for high potential companies	40
Figure 10: Fluctuations in US market P/E ratio (1881-2003)	42
Figure 11: Average P/E ratios for selected US industries	43
Figure 12: Target IRR by country and type of investment.....	44
Figure 13: Generic business model concept.....	50
Figure 14: Financing relationships of a venture capital firm	52
Figure 15: Investors in German private equity funds (2003)	53
Figure 16: Venture capital investments by industries (2003).....	54
Figure 17: Private equity market share of investment companies (2003).....	55
Figure 18: Partnership structure of a venture capital firm.....	58
Figure 19: Number of professionals	60
Figure 20: Educational background.....	60
Figure 21: Professional background.....	61
Figure 22: Specialization in teams.....	62
Figure 23: Refinancing process	63
Figure 24: Importance of investors' investment criteria	64
Figure 25: Performance of European private equity (1980-2002)	68
Figure 26: Typical structure of cash flows to investors	69
Figure 27: Investment process.....	70
Figure 28: Importance of venture capitalists' investment criteria.....	76
Figure 29: Venture capital and private equity financial instruments (2003).....	78
Figure 30: Exit channels of venture capitalists (2003).....	83
Figure 31: Important international growth stock markets	85

Figure 32: Reduction of number of transactions through intermediation	91
Figure 33: Return distributions of direct, fund, and fund-of-funds investments	93
Figure 34: Risk/return measures for direct, fund, and fund-of-funds investments	94
Figure 35: Performance data for several asset classes and benchmark indices	96
Figure 36: Impact of variations in private equity allocation on efficient frontier.....	98
Figure 37: Effects of information rights.....	111
Figure 38: Effects of conversion rights	112
Figure 39: Effects of control rights	117
Figure 40: Effects of management covenants	121
Figure 41: Effects of milestone agreements.....	126
Figure 42: Effects of cash flow rights	130
Figure 43: Effects of preemptive rights.....	132
Figure 44: Effects of disinvestment rights	136
Figure 45: Summary of effects of typical elements in venture capital contracts.....	137
Figure 46: Importance of venture capitalists' activities	143
Figure 47: Resource provision table of venture capital firms	146
Figure 48: Differences in intensity of venture capitalists' activities.....	150
Figure 49: Differing perceptions of the extent of venture capitalists' activities.....	151
Figure 50: Underinvolvement of venture capital firm	152
Figure 51: Prospect theory and its implications for venture capitalists	154
Figure 52: Performance, resource needs and extent of involvement	155
Figure 53: Levels of management.....	164
Figure 54: Degrees of influence and management's autonomy.....	164
Figure 55: Selected data for comparing different accumulator technologies	171
Figure 56: Profiles of Friedemann Stöckert and Dr. Karl-Heinz Pettinger.....	173
Figure 57: Organization chart of Bullith Batteries (2001)	174
Figure 58: Profiles of Dr. Jürgen Diegruber and Tim Stemmer	175
Figure 59: Profiles of Peter Hertig and Janos Gönczöl.....	177
Figure 60: Profile of Dr. Christian Friedemann	183
Figure 61: Contractual analysis of Bullith Batteries' investment agreements.....	191
Figure 62: Deal-specific risks between Gi Ventures and Bullith Batteries	192
Figure 63: Resource-based analysis of Bullith Batteries	196
Figure 64: Profiles of GPC Biotech's founding team	202
Figure 65: Profile of Dr. Helmut Schühsler	203

Figure 66: Profile of Dr. Mirko Scherer	204
Figure 67: Profile of Dr. Michael Steinmetz	205
Figure 68: Profiles of additional members of GPC Biotech's supervisory board.....	208
Figure 69: Profile of Dr. Bernd Seizinger	212
Figure 70: Contractual analysis of GPC Biotech's investment agreements.....	223
Figure 71: Deal-specific risks between MPM Capital, TVM, and GPC Biotech	224
Figure 72: Resource-based analysis of GPC Biotech.....	230
Figure 73: Profit centers of varetis (1986)	237
Figure 74: History of BayBG (1972-2003)	239
Figure 75: Profile of Dr. Wolf Rüdiger Willig.....	241
Figure 76: Product groups of varetis (1999).....	248
Figure 77: Contractual analysis of varetis' first investment agreement.....	254
Figure 78: Contractual analysis of varetis' second investment agreement	256
Figure 79: Deal-specific risks between BayBG and varetis.....	257
Figure 80: Resource-based analysis of varetis	263
Figure 81: Comparison of number of contractual elements	268
Figure 82: Comparison of risks addressed by investment agreements	269
Figure 83: Comparison of contractual elements restraining formal autonomy.....	270
Figure 84: Comparison of direct resource provision by venture capital firms.....	271
Figure 85: Comparison of indirect resource provision by venture capital firms.....	274

Table of Abbreviations

3C-market	Market for Computers, Camcorders and Communication
AIM	Alternative Investment Market
AktG	Aktiengesetz
BayBG	Bayerische Beteiligungsgesellschaft
BNP	Banque National Paribas
BVCA	British Venture Capital Association
BVK	German Venture Capital Association e.V.
CEO	Chief Executive Officer
CFO	Chief Financial Officer
COO	Chief Operating Officer
CTI	Computer Telephony Integration
CTO	Chief Technology Officer
DPI	Distribution to Paid-in
EBT	Earnings before Taxes
EVCA	European Venture Capital and Private Equity Association
FDA	U.S. Food and Drug Administration
IDIS	International Directory Inquiry System
HGB	Handelsgesetzbuch
HVB	HypoVereinsbank AG
IHK	Industrie- und Handelskammer (Bavarian Chamber of Industry and Commerce)
IPO	Initial Public Offering
IPR	Intellectual Property Rights
IRR	Internal Rate of Return

ISiT	Institute for Silicon Technology
IT	Information Technology
KfW	Kreditanstalt für Wiederaufbau
LfA	Landesanstalt für Aufbaufinanzierung
M&A	Mergers & Acquisitions
NASDAQ	National Association of Securities Dealers Automated Quotation System
NDIS	National Directory Inquiry System
NiCd	Nickel-cadmium
NiMH	Nickel metal hydride
NVCA	National Venture Capital Association
OEM	Original Equipment Manufacturer
P/E	Price/Earnings
QST	Inquiry Support for Telecom Operators System
R&D	Research and Development
RVPI	Residual Value to Paid-in
SME	Small- and Medium-sized Enterprises
SWOT	Strengths, Weaknesses, Opportunities and Threats
S&P	Standard & Poor's
tbG	Technologie-Beteiligungs-Gesellschaft
TVPI	Total Value to Paid-in
US	United States of America
WAP	Wireless Application Protocol
ZEW	Center for European Economic Research

Table of Interview Partners

Günther Baierl	Chairman of the Supervisory Board, varetis AG
Dr. Konstantin Becker	Former CFO, varetis AG
Dr. Jürgen Diegruber	Founder and CEO, Gi Ventures AG
Dr. Christian Friedemann	Managing Director, Bullith Batteries AG
Dr. Elmar Maier	Founder and COO, GPC Biotech AG
Dr. Karl-Heinz Pettinger	Founder and Managing Director, Bullith Batteries AG
Dr. Mirko Scherer	Founder and CFO, GPC Biotech AG
Dr. Helmut Schühslers	Managing Partner, Techno Venture Management
Dr. Michael Steinmetz	General Partner, MPM Capital Management
Tim Stemmer	Investment Manager and CTO, Gi Ventures AG
Dr. Wolf Rüdiger Willig	Managing Director, BayBG mbH

1 Introduction

1.1 Relevance of Smart Money

Entrepreneurship and innovation are more than ever essential for securing employment and economic prosperity of a country.¹ The widely discussed finding from BIRCH that most new jobs emanated from entrepreneurial firms in the US market has been substantiated for many other countries.² For Germany, AUDRETSCH/WEIGAND find that strong job growth is only exhibited among the group of small- and medium-sized technology-based firms.³ A better understanding of how this specific group of companies can realize its growth potential is therefore of prime interest.

The bright brains of their founders are often the only assets, which newly founded companies operating at the frontiers of emerging technologies and markets have. This makes an investment in technology-based start-ups very risky. Consequently, many traditional sources of finance from public and private capital markets are not available to cover the financial needs of these companies.

This is where venture capital firms come into play. Following BLACK/GILSON, this analysis defines venture capital as the investment by specialized venture capital firms in high-growth, high-risk, often high-technology firms, therefore called high potential companies, which need capital to finance product development or growth and must, by nature of their business, obtain this capital largely in the form of equity rather than debt.⁴ GIFFORD and SAHLMAN stress that venture capital is “a professionally managed

¹ According to the GLOBAL ENTREPRENEURSHIP MONITOR, start-up firms provide a significant part, ranging from 2% to 15%, of the current jobs in most countries. This job creation is highly correlated with the level of entrepreneurial activity. See GEM (2003a), p. III. The role of innovation in enabling today's economies to grow can not be valued high enough since it accounts for more than half of economic growth. See The Economist (2002).

² See Birch (1987); Birch (1981). Several surveys provide an overview of this literature. See Audretsch (2002); Acs/Audretsch (1993); Eckart/von Einem/Stahl (1987); Fritsch/Hull (1987); Storey/Johnson (1987).

³ See Audretsch/Weigand (1999).

⁴ See Black/Gilson (1998), p. 245. This definition excludes later stage financing, which involves providing capital to companies that are already established. See Achleitner (2001), p. 516. Later-stage financing is often also called private equity financing. See EVCA (2004). It is not to be confused with the concept of private equity financing as opposed to public equity financing via organized capital markets.

pool of capital invested in equity-linked private ventures”.⁵ Other authors add that venture capitalists expect to realize a capital gain by selling their shares after a certain time, which usually amounts to several years.⁶

However, high potential companies do not only lack financial resources. They also require support in several non-financial areas, which the following statement of a venture capitalist illustrates: “To quickly reach ‘critical mass’, young companies today need more than capital. They need access to people and companies who can accelerate their growth by helping them develop strategic partnerships, expand into new markets, raise international expansion financing, cut OEM deals, build distribution channels, secure purchase commitments, and get professional advice.”⁷ Usually, venture capital firms claim that they offer broad non-financial support to their portfolio companies as shown by the following marketing statements of leading venture capital firms:

- *Accel Partners*: “Each of our portfolio companies benefits from the leverage of a deep team of professionals knowledgeable and active in their industry, as well as an extensive network of highly relevant executives and companies built through Accel's previous venture development activity.”⁸
- *Apax Partners*: “[Our portfolio companies can expect from us]⁹, frank, unbiased advice based on our shared financial objectives and over thirty years of experience, assistance with the formation of major advisory relationships, support in the recruitment of high caliber, influential non-executive and executive directors, support and guidance in international expansion through strategic alliances, acquisitions or other means, extensive global knowledge of their sector and technology, an experienced, well connected, international team committed to [the portfolio companies’] success.”¹⁰

⁵ See Gifford (1997), pp. 459 et seq.; Sahlman (1990), p. 473.

⁶ See Achleitner (2001), p. 514; Giudici/Paleari (2000), p. 154.

⁷ Target Partners (2004).

⁸ Accel Partners (2004). Accel Partners is based in London and Palo Alto.

⁹ Remarks in brackets are added by the author.

¹⁰ Apax Partners (2004). Apax Partners is based in Leeds, London, Madrid, Menlo Park, Milan, Munich, New York, Paris, Stockholm, Tel Aviv, Tokyo, and Zurich.

- *Atlas Venture*: “Atlas Venture’s ongoing support helps companies reduce the trial and error inherent in moving from a startup to an established business. Our inside experts expand the reach of the already deep individual involvement of Atlas Venture principals who serve as board members. This program gives portfolio companies in both Europe and the US highly leveraged tools and hands-on assistance in the areas of recruitment, marketing, legal and finance.”¹¹
- *Kleiner Perkins Caufield & Byers*: “Entrepreneurs gain access to our unmatched portfolio of companies and associations with global business leaders. These relationships are the foundations for strategic alliances, partnership opportunities, and the sharing of insights to help build new ventures faster, broader and with less risk.”¹²

The joint provision of capital and non-financial support from a venture capital firm is called “smart money”.¹³ Due to the many non-financial activities that venture capitalists are believed to provide, they are often esteemed to be “company builders rather than financiers”¹⁴ or “consultants with a financial interest”¹⁵. The US venture capital industry can exhibit an impressive track record in building companies that reach a global dimension. Famous names of formerly venture capital-backed companies are Amazon.com, America Online, Amgen, Apple Computer, Cisco Systems, Compaq, DEC, Federal Express, Genentech, Intel, Lotus, Netscape, Oracle, Seagate, Sun Microsystems, 3Com, and Yahoo.¹⁶ The much younger German venture capital industry yet has to prove that it is able to build companies of such global dimension.

However, the “smartness” of the money provided by venture capital firms comes with costs. In fact, entrepreneurs have to accept significant reductions in the valuation of their company as venture capitalists add a smart money premium to their required in-

¹¹ Atlas Venture (2004). Atlas Venture is based in Amsterdam, Boston, London, Munich, and Paris.

¹² Kleiner Perkins Caufield & Byers (2004). Kleiner Perkins Caufield & Byers is based in Menlo Park and San Francisco.

¹³ Cf. Kreditanstalt für Wiederaufbau (2003), p. 18; Bascha/Walz (2002), p. 1; Lange et al. (2001); Baums/Möller (2000), p. 3.

¹⁴ Smart/Payne/Yuzaki (2000), p. 16.

¹⁵ Fried/Hisrich (1995), p. 102.

¹⁶ See Kenney (2000), p. 2.