Entrepreneurial and Financial Studies
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Christian H. Fingerle

Smart Money –
Influence of Venture Capitalists on High Potential Companies

Verlag Wissenschaft & Praxis

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Herausgegeben von

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Band 7

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Bibliografische Information der Deutschen Bibliothek

Die Deutsche Bibliothek verzeichnet diese Publikation in
der Deutschen Nationalbibliografie; detaillierte bibliografische Daten
sind im Internet über http://dnb.ddb.de abrufbar.

ISBN 3-89673-260-9

Dr. Brauner GmbH 2005
D-75447 Sternenfels, Nußbaumweg 6
Tel. 07045/930093 Fax 07045/930094

Printed in Germany

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

Acknowledgments

With the following lines, I want to express my sincere appreciation and gratitude to the many individuals whose cooperation and support were essential to the completion of this book that results from my work at KfW Endowed Chair in Entrepreneurial Finance, Munich University of Technology (TUM).

First and foremost, I very much thank Professor Ann-Kristin Achleitner for giving me the exceptional opportunity of working together with her for three years. Her thoughtful guidance in pursuing my research agenda and her perpetual availability for discussion have been a tremendous help. Most importantly, I thank her for the trust and respect that I experienced right from the beginning and that made me enjoy every day of my work.

I am indebted to several members of the faculty of TUM Business School. In particular, I very much would like to thank Professor Christoph Kaserer for acting as referee for my dissertation and for always supporting my projects as member of the Center for Entrepreneurial and Financial Studies. In addition, I would also like to thank Professor Wolfgang Lück for assuming the chair of my doctoral examination committee and giving me the opportunity to attend his doctoral seminars.

This work benefited to a large degree from the extensive support of the following entrepreneurs and venture capitalists:

- Dr. Mirko Scherer, Dr. Elmar Maier and Dr. Markus Maier (GPC Biotech AG),
- 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).

For their personal commitment and the many hours spent in interviews, discussions and proof-readings, I would like to express my sincere appreciation and deepest gratitude. The interaction with these outstanding individuals greatly enriched my scientific analysis and extended my personal horizon. For their invaluable support and endurance in preparing the case studies, I would also like to thank Johanna Rüttinger, Dr. Monika Labes, and Sven Eppert.

To my colleagues at TUM Business School I want to express my deepest gratitude for their intellectual and emotional support that went well beyond this book. Above all, I thank Dr. Simon J. Wahl and Dr. Eva Nathusius for the unique team spirit and the many memorable moments that we enjoyed together starting with the Founders' Forum in Schloß Elmau. I am grateful to Kay Müller and Annabell Geidner for keeping up and broadening this team spirit besides their invaluable input to my work in numerous discussions. I would also like to thank Thorsten Groth, Martin Brixner, Benjamin Moldenhauer and Dr. Angela Poech for several significant contributions to my work. I'm also very grateful to Professor Alexander Bassen for his valuable advice and support over the years. Furthermore, I would like to thank Monika Paul and Evelin Winands for supporting me in many aspects of my daily work. For their excellence assistance in several projects, I am grateful to Michael Lutz and Elisabeth Tyroller. For his valuable comments on my manuscript, I am also indebted to Dominik Jais.

I would very much like to thank Nicole Hinn for her love and moral support during the final phase of the completion of this work. Above all, I thank my parents, Ilse and Herbert Fingerle, for their love, encouragement and support over all the years.

Munich, 1 June 2005

Dr. Christian H. Fingerle

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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 Schühsler	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

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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]

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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-

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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.