The Challenge of Venture Capital for Growing Ventures

Key Topics
- Determining Capital Requirements
- Pro Forma Statements
- Equity Financing
- The Venture Capital Market
- Informal Risk Capital—Angel Financing

The Entrepreneurial Library
The Influence of a Venture Capitalist’s Source of Funding

Comprehensive Case Study
Should I Buy the Jerry’s Famous Frozen Desserts’ Chain?

Introduction
Entrepreneurs must become experts not only in their industry but also finance. Successfully seeking funding and diligently administering the day-to-day finances are critical skills that must be mastered. Too often entrepreneurs conceive an idea for a new product or service and become overly enamored with it without tending to the resources required to bring it to market. Financing is a critical element in the entrepreneurship development process, especially for those who expect to grow their business.
DETERMINING CAPITAL REQUIREMENTS

Much time and effort is devoted to the question of fund-raising—where to find money, terms and conditions of repayment, and how ownership and control interests will be divided. Surprisingly little attention is sometimes given to one of the most important questions: How much is enough?

How much money is needed to start a growth company? If the Inc. 500 most successful firms of 2002 are any indicator, not much. Forty-one percent of these firms launched their business with less than $10,000, and fully one-third needed less than $1,000. Over the years, more than one-half of Inc. 500 entrepreneurs started their company with partners: 62 percent in 2001 and 2002, and 55 percent in 2000. In 2002, 28 percent of CEOs reported that their co-founders contributed seed capital (see Table 11.1).

Some entrepreneurs will argue that there is never enough funding and that the entrepreneur should raise as much funding as is available, then use it. However, there are two reasons that this strategy is unwise: the cost of capital and the appearance of preparedness. For the Inc. 500, a successful group of high-growth firms, a large number started with limited capital (41 percent with less than $10,000) than with abundant capital (34 percent more than $50,000). See Table 11.2.

Eventually, anyone planning a business must approach individuals or organizations with the plan and a request for money. When an entrepreneur sets out to demonstrate that the Venture is well-conceived and viable, he or she must have a clear idea of how much money is needed and some hard data to explain how the funds will be used. This will help convey an image of professionalism. No investor wants to be told that a proposed venture will require as much as he or she can give.

| TABLE 11.1 |
| Capital Sources for Entrepreneurs |
| | 1999–2002 INC. 500 FIRMS |
| Co-founders | 28% | 39% | 36% | 8% |
| Family or friends | 19% | 30% | 33% | 14% |
| Strategic partners | 7% | 11% | 6% | 4% |


| TABLE 11.2 |
| Inc. 500 Firms Launched with Seed Capital |
| Amount of Seed Capital | Percent Firms |
| Less than $1,000 | 14 |
| $1,000 to $10,000 | 27 |
| $10,001 to $20,000 | 10 |
| $20,001 to $50,000 | 15 |
| $50,001 to $100,000 | 12 |
| More than $100,000 | 22 |

PRO FORMA STATEMENTS

The basis of determining capital requirements is the business plan. In creating the business plan, the entrepreneur has undertaken a thorough examination of the workings of the proposed business—its income and expenses, its risks and rewards. One of the results of research done in creating the business plan is a set of pro forma financial statements—the projected financial state of the business. The financial section of the business plan will include projected statements of assets and liabilities, income, and cash flows. Because cash is the blood of a business, the cash flow statement is the most important of these for determining the overall capital requirements of the venture. Even if the business is profitable on paper, a cash shortage can cause its demise.

Because the cash flow statement is the basis of a funding proposal and because a business starved of cash will cease to operate, it is vital to review the assumptions used in the pro forma statements for accuracy before deciding how much money is needed.

In order to ensure enough operating cash, the entrepreneur should ensure that all start-up expenses are taken into account. Legal fees, marketing expenses, travel, office supplies, rent and security deposits, and permits and licenses represent just some of the expenses that can be overlooked. Enough unexpected expenses will arise that it is essential to plan for everything that can be predicted.

In addition to the startup expenses, the cash flow projections should be reviewed to ensure that they are consistent with the sales and operations projections. If you plan to sell and deliver 1,000 units in May, the raw materials or inventory expenses must reflect those levels. There must be adequate sales force to make those sales and enough trucks to make the deliveries. When will your projected sales increases necessitate more space, an expanded sales force, or augmented distribution equipment?

Once the entrepreneur has assured himself or herself that the projections are complete, inclusive, consistent, and accurately represent the most likely path of the company, the data can be used to assess funding needs.

Conservative Projections

In order to assess the capital requirements of a new venture, the best starting point is a candid and conservative best guess based on the most likely projections. This best guess starts with the pro forma statement of cash flows. The data from this document will determine the capital needs of operating the business.

The statement of cash flows represents a best guess for the flow of useable money into or out of your business. By adding the cash flows from month to month, a cumulative cash flow figure is reached for the end of each month. In the early months, as money buys equipment and raw materials and pays for production, marketing, and other start-up expenses, the monthly cash flows will be negative, and the cumulative cash flow figure will be a larger negative number each month. As the business grows, it will eventually produce positive cash flows. As cash comes into the business, cumulative cash flows begin to increase and slowly return to positive figures.

In order to have enough money to continue operations of your business, you will need to have at least enough to cover the negative cash flows that the venture is projected to produce. This means that when the cumulative cash flow figure reaches its largest negative value, it represents the amount of cash needed at the outset to launch the business according to plan.

Any experienced entrepreneur will tell you that a new venture very rarely proceeds according to plan. To allow for variances from the best guess, the amount of capital

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raised should be somewhat larger than the amount suggested by cash flow projections. Two methods of adjusting the figure have been suggested: a defined cushion and scenario building.

The Defined Cushion

One method of adjusting the capital requirement is to add a cushion of a specific size to cover the unexpected. The exact amount of the cushion may vary from business to business and with the nature of the risks. Often, this cushion is calculated based on a percentage of the total requirement, or on a period of time of operations. For example, a cushion may consist of 10% of the expected requirement, or six months of fixed expenses.

Scenario Building

The other method for adjusting the capital requirement is to adjust the assumptions and projections made in the financial plan in order to determine the business’s needs under different conditions. While the financial plan will represent the expected or most likely case, many entrepreneurs find it helpful for planning to examine the best likely case and the worst likely case.

Comparing the financial needs of different scenarios is helpful in determining the capital requirements of the venture. It also helps entrepreneurs examine the drivers of their business and discover which operational and marketing aspects of the business will make the biggest differences to the venture’s cash flow.

It is important to recognize that the best likely case will usually require more funding than the worst likely case. Under the best-case scenario, sales grow quickly. Increased sales mean increased expenses for inventory, sales force, production, and distribution. Skyrocketing sales may require new facilities, machinery, or modes of transportation—all significant expenses. The faster sales grow, the more working capital is needed. In the worst-case scenario, sales lag and inventory idles. Sales, production, or distribution personnel may be laid off. Under these conditions, less cash is absorbed by the business.

Equity Financing

For those entrepreneurs who are willing to give up some of their profits in order to run their businesses with less risk to themselves, equity financing can provide an attractive way to raise funds. In equity financing, an investor buys a share of ownership in the new venture. If the venture fails, the investor stands to lose the entire investment. If the venture succeeds, however, the investor’s return is not limited to an interest payment.

Not all aspects of equity financing are always preferable, though. Shared ownership often means increased involvement for investors. With their money at risk, investors sometimes require that they be consulted on major decisions. The sharing of a percentage of profits with investors also detracts from the attractiveness of an equity deal. Equity financing generally fits one of several categories that we now describe.

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*2Ibid.*


Informal Investors

The most common source of equity capital for start-up ventures is informal investing. Investors in this category are often family, friends, or colleagues. Because these potential investors are known to the entrepreneur, connections and deals are often made informally and more quickly than with other forms of equity. Many entrepreneurs find it easy to involve family, friends, and colleagues because they are easy to find, and they are already familiar with the character, skills, and drive of the entrepreneur in whom they are investing. Informal investors generally contribute a specified sum of money to a new venture and in return receive a specified portion of the profits. Deal structures vary widely, but generally, they include some involvement of or reporting to investors.

Researchers have measured informal investment in the United States amount to almost $130 million annually.\(^5\)

Private Placement

Equity funded through private placement is similar to informal investing in that it involves a trade of money for ownership rights. Formal private placement, however, generally involves larger amounts of money and a greater number of investors.

Private placements are governed by the Securities and Exchange Commission under Regulation D, which lays out requirements of a private offering, including a thorough business plan and a full accounting of the risks involved in the investment. Attorneys are always involved in formal private placements, and sometimes a brokerage firm is enlisted to issue the securities changing hands. Where informal investors collectively inject about $130 million into the economy annually, a single private placement sale can dwarf that number. In 2001, the CEMEX Company conducted a single private placement sale for $757 million.\(^6\)

Public Stock: The IPO

The largest infusions of capital are realized through the issuance of public stock. Companies that make an Initial Public Offering (IPO) allow their ownership shares to be traded on the public market to anyone who wishes to pay for them. While this can generate an enormous cash inflow, the IPO is extremely complex, expensive, and highly regulated.

Typically, IPOs are conducted through an investment banking firm, which will issue the stock and help ensure compliance with regulations. In return, the investment bankers will take a portion of the proceeds of the initial sale. An investment bank, in addition to aiding the mechanics of an initial public offering, generally has the resources to help companies with market research, business consulting services, business contacts, and negotiations, among other things.\(^7\)

The expenses associated with IPOs can be huge, and the costs are generally borne by the company until stock is issued and money collected. In addition to investment bankers, the process generally involves attorneys, accountants, tax specialists, media rela-

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tions professionals, and others. The entrepreneur generally travels, pitching his or her idea to investors (this is known as the road show). After all this outlay, there is no guarantee of a payoff. Many companies spend months preparing for an IPO, only to have the deal fall through. More than one company has failed after sinking all their funds into a failed IPO.8

After an IPO, the company is subject to ongoing scrutiny from governmental and shareholder groups, and it will experience a new set of pressures not felt by private companies. Entrepreneurs who previously answered to no one find themselves “in the fishbowl”—under the constant watch of outside parties. This can be particularly difficult for owner/managers who had been in the habit of keeping financial information and strategies secret. Many entrepreneurs are forced from their positions as chief executives in favor of more experienced, professional CEOs.

IPO funding represents by far the most money exchanged of any equity type. In September of 2002, the investment community was complaining that only $22.5 billion in IPOs had been conducted that year.9 The most complex and arduous type of equity funding, however, is generally the most lucrative for entrepreneurs when successful.

THE VENTURE CAPITAL MARKET

Venture capitalists are a valuable and powerful source of equity funding for new ventures. These experienced professionals provide a full range of financial services for new or growing ventures, including the following:

- Capital for start-ups and expansion
- Market research and strategy for businesses that do not have their own marketing department
- Management-consulting functions and management audit and evaluation
- Contacts with prospective customers, suppliers, and other important businesspeople
- Assistance in negotiating technical agreements
- Help in establishing management and accounting controls
- Help in employee recruitment and development of employee agreements
- Help in risk management and the establishment of an effective insurance program
- Counseling and guidance in complying with a myriad of government regulations

Recent Developments in Venture Capital

In the year 2000, the venture capital industry experienced a record year with $108.8 billion invested in 8,404 companies (see Table 11.3). However, due to the downturn in the economy, venture capital investments dropped to $42.9 billion in 4,932 companies in 2001. Over the past few years, funding for Internet ventures of all types grew substantially. For example, in 1999 Internet firms attracted $31.9 billion—an increase of 811 percent over the amount placed in 1998.

In addition, it is interesting to note where the venture capitalists are investing their money. Table 11.4 provides a breakdown of the growth in venture capital disbursements.

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TABLE II.4
Venture Capital Invested by Industry

<table>
<thead>
<tr>
<th>Industry</th>
<th>1998 Total</th>
<th>1999 Total</th>
<th>2000 Total</th>
<th>2001 Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>Biotechnology</td>
<td>$1,557,750,500</td>
<td>$2,200,317,500</td>
<td>$3,711,912,500</td>
<td>$3,439,493,100</td>
</tr>
<tr>
<td>Business products and services</td>
<td>436,858,100</td>
<td>1,432,352,200</td>
<td>2,102,715,300</td>
<td>549,444,000</td>
</tr>
<tr>
<td>Computers and peripherals</td>
<td>538,721,800</td>
<td>1,218,601,700</td>
<td>2,659,408,600</td>
<td>1,106,650,900</td>
</tr>
<tr>
<td>Consumer products and services</td>
<td>601,640,900</td>
<td>683,811,400</td>
<td>1,147,244,100</td>
<td>591,898,500</td>
</tr>
<tr>
<td>Electronics/Instrumentation</td>
<td>303,625,800</td>
<td>383,648,300</td>
<td>946,950,600</td>
<td>427,085,800</td>
</tr>
<tr>
<td>Financial services</td>
<td>971,205,300</td>
<td>735,365,800</td>
<td>720,494,400</td>
<td>600,798,900</td>
</tr>
<tr>
<td>Healthcare services</td>
<td>828,813,300</td>
<td>696,755,500</td>
<td>634,956,500</td>
<td>442,822,300</td>
</tr>
<tr>
<td>Industrial/Energy</td>
<td>1,429,397,700</td>
<td>1,707,777,400</td>
<td>2,614,627,000</td>
<td>1,384,481,800</td>
</tr>
<tr>
<td>IT services</td>
<td>1,261,397,400</td>
<td>4,164,588,400</td>
<td>9,377,665,900</td>
<td>2,952,589,200</td>
</tr>
<tr>
<td>Media and entertainment</td>
<td>1,640,160,500</td>
<td>3,513,399,000</td>
<td>8,787,702,800</td>
<td>2,290,178,600</td>
</tr>
<tr>
<td>Medical devices and equipment</td>
<td>1,243,705,200</td>
<td>1,525,037,800</td>
<td>2,643,802,000</td>
<td>2,032,066,500</td>
</tr>
<tr>
<td>Networking and equipment</td>
<td>1,149,121,600</td>
<td>4,464,288,800</td>
<td>11,778,480,900</td>
<td>5,865,179,200</td>
</tr>
<tr>
<td>Other</td>
<td>27,521,300</td>
<td>241,491,600</td>
<td>272,079,200</td>
<td>156,731,000</td>
</tr>
<tr>
<td>Retailing/Distribution</td>
<td>2,115,565,100</td>
<td>12,815,847,500</td>
<td>19,739,781,200</td>
<td>4,272,876,700</td>
</tr>
<tr>
<td>Semiconductors</td>
<td>325,930,200</td>
<td>1,220,794,000</td>
<td>3,211,675,000</td>
<td>1,813,728,200</td>
</tr>
<tr>
<td>Software</td>
<td>4,100,197,600</td>
<td>9,438,335,000</td>
<td>19,984,146,100</td>
<td>8,512,308,500</td>
</tr>
<tr>
<td>Telecommunications</td>
<td>8,788,505,500</td>
<td>8,130,075,100</td>
<td>17,855,099,800</td>
<td>6,472,255,600</td>
</tr>
<tr>
<td>Grand total</td>
<td>$22,210,334,100</td>
<td>$56,525,619,000</td>
<td>$108,748,754,900</td>
<td>$42,910,588,800</td>
</tr>
</tbody>
</table>

Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association Money Tree Survey.

In industry from 1998 to 2001. More significant is the venture capital investment by stages of a venture’s development. Table 11.4 illustrates the emphasis placed on early stages and expansions by venture capitalists in terms of dollars invested and number of companies from 1998 to 2001.

In 1999, 50 percent of the 544 initial public offerings made in that year were venture-backed, up from 20 percent in 1998. Also in 1999, 271 venture-backed companies went public, raising $23.6 billion. Venture-backed IPOs helped fuel the growth of the strong NASDAQ stock market, whose composite index was up 85.6 percent in 1999.

Venture-backed companies have raised more dollars and have gone public at an earlier age. In 1999, for example, the average offer size increased by 75 percent from that seen in the previous year, with the average offer size being $87.2 million. Postoffer valuations more than doubled, reaching an average of $502 million. The median company
The age of venture-backed IPOs were 4.0 years in 1999 versus 4.5 years in 1998 and 5.5 years in 1997.10

In addition to these developments, a number of major trends have been occurring in venture capital over the last few years.

First, the predominant investor class is changing from individuals, foundations, and families to pension institutions. Therefore, sources of capital commitments will continue to shift away from the less-experienced venture capital firms (less than three years) to the more-experienced firm (greater than three years). Second, funds are becoming more specialized and less homogeneous. The industry has become more diverse, more specialized and less uniform than is generally thought. Sharp differences are apparent in terms of investing objectives and criteria, strategy, and focusing on particular stages, sizes, and market technology niches.11

Third, feeder funds are emerging. Accompanying this specialization is a new farm team system. Large, established venture capital firms have crafted both formal and informal relationships with new funds as feeder funds. Often, one general partner of the established fund will provide time and know-how to the new fund. The team may share deal flow and co-invest in a syndicated deal. More often than not, these funds focus on seed-stage or start-up deals that can feed later deals to the more conventional, mainstream venture capital firm with which they are associated.12

Fourth, small start-up investments are drying up. Many venture capital firms have numerous troubled ventures in their portfolios. As a result, general partners, who are often the most experienced and skillful at finding and nurturing innovative technological ventures, are allocating premium time to salvaging or turning around problem ventures. In addition, because start-up and first-stage investing demands the greatest intensity of involvement by venture capital investors, this type of venture has felt the greatest effects. Finally, other venture capital funds lack professionals who have experience with start-ups and first-stage ventures. Consequently, the level of seed and start-up financing is lower in comparison to the financing available for early stages, expansion, and acquisition. Table 11.5 describes venture capital disbursements by stage.

Fifth, the trend is toward a new legal environment. The heated competition for venture capital in recent years has resulted in a more-sophisticated legal and contractual environment. The frequency and extent of litigation are rising. As an example, the final document governing the investor/entrepreneur relationship—called the investment agreement—can be a few inches thick and can comprise two volumes. In this regard, legal experts recommend that the following provisions be carefully considered in the investment agreement: choice of securities (preferred stock, common stock, convertible debt, and so forth), control issues (who maintains voting power), evaluation issues and

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TABLE 11.5
Venture Capital Investments by Stages of Venture Development

| STAGE OF DEVELOPMENT | 2001  |  |  |  |  |  |  |  |
|----------------------|-------|---|---|---|---|---|---|
|                      | Amount (In Billions) | Companies | Amount (In Billions) | Companies | Amount (In Billions) | Companies | Amount (In Billions) | Companies |
| Start-Up/Seed        | 540.6 | 193 | 2,311.6 | 537 | 3,324.5 | 816 | 1,857.8 | 727 |
| Early stage          | 4,682.9 | 642 | 16,499.5 | 1,872 | 12,372.2 | 1,728 | 5,518.2 | 1,039 |
| Expansion            | 1,911.1 | 291 | 9,654.7 | 853 | 31,724.1 | 2,676 | 2,676 | 2,058 |
| Later stage          | 229.4 | 41 | 718.5 | 77 | 9,041.6 | 602 | 3,509.6 | 40 |

Source: PricewaterhouseCoopers/Venture Economics/National Venture Capital Association Money Tree Survey.

TABLE 11.6
Returns on Investment Typically Sought by Venture Capitalists

<table>
<thead>
<tr>
<th>Stage of Business</th>
<th>Expected Annual Return on Investment</th>
<th>Expected Increase on Initial Investment</th>
</tr>
</thead>
<tbody>
<tr>
<td>Start-up business (idea stage)</td>
<td>60% +</td>
<td>10–15 × investment</td>
</tr>
<tr>
<td>First-stage financing (new business)</td>
<td>50–60%</td>
<td>6–12 × investment</td>
</tr>
<tr>
<td>Second-stage financing (development stage)</td>
<td>30%–50%</td>
<td>4–8 × investment</td>
</tr>
<tr>
<td>Third-stage financing (expansion stage)</td>
<td>25%–40%</td>
<td>3–6 × investment</td>
</tr>
<tr>
<td>Turnaround situation</td>
<td>50% +</td>
<td>8–15 × investment</td>
</tr>
</tbody>
</table>


financial covenants (ability to proceed with mergers and acquisitions), and remedies for breach of contract (rescission of the contract or monetary damages).14

Venture Capitalist Objectives

Venture capitalists have different objectives from most others who provide capital to new ventures. Lenders, for example, are interested in security and payback. As partial owners of the companies they invest in, venture capitalists, however, are most concerned with return on investment. As a result, they put a great deal of time into weighing the risk of a venture against the potential return. They carefully measure both the product/service and the management.

Venture capitalists are particularly interested in making large returns on investments. Table 11.6 provides some commonly sought targets. Of course, these targets are flexible. They would be reduced, for example, in cases where a company has a strong market potential, is able to generate good cash flow, or the management has invested a sizable portion of its own funds in the venture.15

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TABLE 11.7
Factors in Venture Capitalists’ Evaluation Process

<table>
<thead>
<tr>
<th>Attribute</th>
<th>Level</th>
<th>Definition</th>
</tr>
</thead>
<tbody>
<tr>
<td>Timing of entry</td>
<td>Pioneer</td>
<td>Enters a new industry first</td>
</tr>
<tr>
<td></td>
<td>Late follower</td>
<td>Enters an industry late in the industry’s stage of development</td>
</tr>
<tr>
<td>Key success factor stability</td>
<td>High</td>
<td>Requirements necessary for success will not change radically during industry development</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Requirements necessary for success will change radically during industry development</td>
</tr>
<tr>
<td>Educational capability</td>
<td>High</td>
<td>Considerable resources and skills available to overcome market ignorance through education</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Few resources or skills available to overcome market ignorance through education</td>
</tr>
<tr>
<td>Lead time</td>
<td>Long</td>
<td>An extended period of monopoly for the first entrant prior to competitors entering the industry</td>
</tr>
<tr>
<td></td>
<td>Short</td>
<td>A minimal period of monopoly for the first entrant prior to competitors entering this industry</td>
</tr>
<tr>
<td>Competitive rivalry</td>
<td>High</td>
<td>Intense competition among industry members during industry development</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Little competition among industry members during industry development</td>
</tr>
<tr>
<td>Entry wedge mimicry</td>
<td>High</td>
<td>Considerable imitation of the mechanisms used by other firms to enter this, or any other, industry—for example, a franchisee</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Minimal imitation of the mechanisms used by other firms to enter this, or any other, industry—for example, introducing a new product</td>
</tr>
<tr>
<td>Scope</td>
<td>Broad</td>
<td>A firm that spreads its resources across a wide spectrum of the market—for example, many segments of the market</td>
</tr>
<tr>
<td></td>
<td>Narrow</td>
<td>A firm that concentrates on intensively exploiting a small segment of the market—for example, targeting a niche</td>
</tr>
<tr>
<td>Industry-related competence</td>
<td>High</td>
<td>Venture has considerable experience and knowledge with the industry being entered or related industry</td>
</tr>
<tr>
<td></td>
<td>Low</td>
<td>Venture has minimal experience and knowledge with the industry being entered or related industry</td>
</tr>
</tbody>
</table>


In addition to the evaluation of product ideas and management strength, numerous criteria are used to evaluate new-venture proposals. Researcher Dean A. Shepherd developed a list of eight critical factors that venture capitalists use in the evaluation of new ventures. Timing of entry, key success factor stability, educational capability, lead time, competitive rivalry, entry wedge imitation, scope, and industry-related competence were all considered factors that are used by venture capitalists. Each factor was defined from the high/low perspective (See Table 11.7 for definitions).

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The evaluation process typically takes place in stages. The four most common stages follow.

**Stage 1: Initial Screening.** This quick review of the basic venture to see if it meets the venture capitalist’s particular interests.

**Stage 2: Evaluation of the Business Plan.** This is where a detailed reading of the plan is done in order to evaluate the factors mentioned earlier.

**Stage 3: Oral Presentation.** The entrepreneur verbally presents the plan to the venture capitalist.

**Stage 4: Final Evaluation.** After analyzing the plan and visiting with suppliers, customers, consultants, and others, the venture capitalist makes a final decision.

This four-step process screens out approximately 98 percent of all venture plans. The rest receive some degree of financial backing.

**Evaluating the Venture Capitalist**

The venture capitalist will evaluate the entrepreneur’s proposal carefully, and the entrepreneur should not hesitate to evaluate the venture capitalist. Does the venture capitalist understand the proposal? Is the individual familiar with the business? Is the person someone with whom the entrepreneur can work? If the answers reveal a poor fit, it is best for the entrepreneur to look for a different venture capitalist.

One researcher found that venture capitalists do add value to an entrepreneurial firm beyond the money they supply, especially in high-innovation ventures. Because of this finding, entrepreneurs need to choose the appropriate venture capitalist at the outset, and most important, they must keep the communication channels open as the firm grows.17

On the other hand, it is important to realize that the choice of a venture capitalist can be limited. Although funds are available today, they tend to be controlled by fewer groups, and the quality of the venture must be promising. Even though two and one-half times more money is available today for seed financing than was available ten years ago, the number of venture capital firms is not increasing. In addition, the trend toward concentration of venture capital under the control of a few firms is increasing.18

Nevertheless, the entrepreneur should not be deterred from evaluating prospective venture capitalists.

**Dispelling Venture Capital Myths**

Because many people have mistaken ideas about the role and function of venture capitalists, a number of myths have sprung up about venture capitalists. Some of these, along with their rebuttals, follow.

**Myth 1: Venture Capital Firms Want to Gain Control of Your Company and Tell You How to Run the Business.** No venture capital firm intentionally sets out to control a small business. Venture capitalists have no desire to run the business. They do not want to tell entrepreneurs how to make day-to-day decisions and have the

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owner report to them daily. They want the entrepreneur and the management team to run the company profitably. They do want to be consulted on any major decision, but they want no say in daily business operations.19

Myth 2: Venture Capitalists are Satisfied with a Reasonable Return on Investments. Venture capitalists expect very high, exorbitant, unreasonable returns. They can obtain reasonable returns from hundreds of publicly traded companies. They can obtain reasonable returns from many types of investments not having the degree of risk involved with financing a small business. Because every venture capital investment involves a high degree of risk, it must have a correspondingly high return on investment.20

Myth 3: Venture Capitalists Are Quick to Invest. It takes a long time to raise venture capital. On average, it will take six to eight weeks from the initial contact to raise venture capital. If the entrepreneur has a well-prepared business plan, the investor will be able to raise money in that time frame. A venture capitalist will see from 50 to 100 proposals a month. Out of that number, 10 will be of some interest. Out of those 10, 2 or 3 will receive a fair amount of analysis, negotiation, and investigation. Of the 2 or 3, 1 may be funded. This funneling process of selecting 1 out of 100 takes a great deal of time. Once the venture capitalist has found that one, he or she will spend a significant amount of time investigating possible outcomes before funding it.

Myth 4: Venture Capitalists Are Interested in Backing New Ideas or High-Technology Inventions—Management Is a Secondary Consideration. Venture capitalists back only good management. If an entrepreneur has a bright idea but a poor managerial background and no experience in the industry, the individual should try to find someone in the industry to bring onto the team. The venture capitalist will have a hard time believing that an entrepreneur with no experience in that industry and no managerial ability in his or her background can follow through on a business plan. A good idea is important, but a good management team is even more important.21

Myth 5: Venture Capitalists Need Only Basic Summary Information Before They Make an Investment. A detailed and well-organized business plan is the only way to gain a venture capital investor’s attention and obtain funding. Every venture capitalist, before becoming involved, wants the entrepreneur to have thought out the entire business plan and to have written it down in detail.22

**Informal Risk Capital—“Angel” Financing**

Not all venture capital is raised through formal sources such as public and private placements. Many wealthy people in the United States are looking for investment opportunities. They are referred to as business angels or informal risk capitalists.

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These individuals constitute a huge potential investment pool. William E. Wetzel, Jr., noted researcher in the field of informal risk capital, has defined this type of investor as someone who has already made his or her money and now seeks out promising young ventures to support financially. “Angels are typically entrepreneurs, retired corporate executives, or professionals who have a net worth of more than $1 million and an income of more than $100,000 a year. They’re self-starters. And they’re trying to perpetuate the system that made them successful.”23

Types of Angel Investors

Angel investors can be classified into five basic groups:

1. Corporate angels. Typically, so-called corporate angels are senior managers at Fortune 1000 corporations who have been laid off with generous severances or have taken early retirement. In addition to receiving the cash, an entrepreneur may persuade the corporate angel to occupy some senior management position, such as in business development.

2. Entrepreneurial angels. The most prevalent type of investor, most of these individuals own and operate highly successful businesses. Because these investors have other sources of income, and perhaps significant wealth from IPOs or partial buyouts, they will take bigger risks and invest more capital. The best way to market your deal to these angels, therefore, is as a synergistic opportunity. Reflecting this orientation, entrepreneurial angels seldom look at companies outside of their own area of expertise and will participate in no more than a handful of investments at any time. These investors almost always take a seat on the board of directors but rarely assume management duties. They will make fair-sized investments—typically, $200,000 to $500,000—and invest more as the company progresses.

3. Enthusiast angels. Whereas entrepreneurial angels tend to be somewhat calculating, enthusiasts simply like to be involved in deals. Most enthusiast angels are age 65 or older, independently wealthy from success in business they started, and have abbreviated work schedules. For them, investing is a hobby. As a result, they typically play no role in management and rarely seek to be placed on a board. Because they spread themselves across so many companies, the size of their investment tends to be small—ranging from as little as $10,000 to perhaps a few hundred thousand dollars.

4. Micromanagement angels. Micromanagers are very serious investors. Some of them are born wealthy, but the vast majority attain wealth through their own efforts. Unfortunately, this heritage makes them dangerous. Because most have successfully built a company, micromanagers attempt to impose the tactics that worked for them on their portfolio companies. Although they do not seek an active management role, micromanagers usually demand a seat on the board of directors. If business is not going well, they will try to bring in new managers.

5. Professional angels. The term professional in this context refers to the investor’s occupation, such as doctor, lawyer, and in some very rare instances, accountant. Professional angels like to invest in companies that offer a product or service with which they have some experience. They rarely seek a board seat, but they can be unpleasant to deal with when the going gets rough and may believe that a com-

---

pany is in trouble before it actually is. Professional angels will invest in several companies at one time, and their capital contributions range from $25,000 to $200,000.24

The importance of understanding the role of informal risk capital is illustrated by the fact that the pool of today’s angel capital is 5 times the amount in the institutional venture capital market, providing money to 20 to 30 times as many companies. Angels invest more than $20 billion a year in 30,000 to 40,000 companies nationwide, twice the amount of money and twice the number of companies ten years ago.25

Why would individuals be interested in investing in a new venture from which professional venture capitalists see no powerful payoff? It may be, of course, that the reduced investment amount reduces the total risk involved in the investment. However, informal investors seek other, nonfinancial returns, among them the creation of jobs in areas of high unemployment, development of technology for social needs (for example, medical or energy), urban revitalization, minority or disadvantaged assistance, and personal satisfaction from assisting entrepreneurs. Table 11.8 describes the major differences between business angels and venture capitalists.

How do informal investors find projects? Research studies indicate that they use a network of friends. In addition, many states are formulating venture capital networks, which attempt to link informal investors with entrepreneurs and their new or growing ventures.

One newly created source is the Angel Capital Electronic Network (ACE-Net). This Internet-based service provides information to institutional and individual accredited investors about small, dynamic, growing businesses seeking $250,000 to $5 million in equity financing. ACE-Net is not a loan program, but rather a securities listing service that operates under a “no action” letter from the SEC. It is not a matching service and does not serve as an investment advisor. In addition, no securities trading takes place on ACE-Net.

### Table 11.8

<table>
<thead>
<tr>
<th>Main Differences</th>
<th>Business Angels</th>
<th>Venture Capitalists</th>
</tr>
</thead>
<tbody>
<tr>
<td>Personal</td>
<td>Entrepreneurs</td>
<td>Investors</td>
</tr>
<tr>
<td>Firms funded</td>
<td>Small, early-stage</td>
<td>Large, mature</td>
</tr>
<tr>
<td>Due diligence done</td>
<td>Minimal</td>
<td>Extensive</td>
</tr>
<tr>
<td>Location of investment</td>
<td>Of concern</td>
<td>Not important</td>
</tr>
<tr>
<td>Contract used</td>
<td>Simple</td>
<td>Comprehensive</td>
</tr>
<tr>
<td>Monitoring after investment</td>
<td>Active, hands-on</td>
<td>Strategic</td>
</tr>
<tr>
<td>Exiting the firm</td>
<td>Of lesser concern</td>
<td>Highly important</td>
</tr>
<tr>
<td>Rate of return</td>
<td>Of lesser concern</td>
<td>Highly important</td>
</tr>
</tbody>
</table>

Source: Mark Van Osnabrugge and Robert J. Robinson, Angel Investing, Jossey-Bass. © 2000, 111. This material is used by permission of John Wiley & Sons, Inc.

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Instead ACE-Net, which is sponsored by the Office of Advocacy of the U.S. Small Business Administration, represents a major effort to systematically develop a national marketplace for small company securities offerings. It also provides, on a nationwide basis, an expanding database available to investors on firms seeking equity financing.26

The Influence of a Venture Capitalist’s Source of Funds

Mark Van Osnabrugge, Marakon Associates

Robert J. Robinson, Harvard University


In observing the growing presence of venture capital firms in our financial landscape, most commentators concentrate on the structural questions of size of deals, sector investing focus, and the issues of risk and reward. Little, if any, consideration is given to the source of the venture capitalist’s own funding, and how this may affect the structure, investing behaviour, and informational strategies of the venture capital firm itself. This study examines the management styles and investment preferences of the two primary types of venture capital firms “captives” and “independents,” in an effort to gain insight into the sorts of structural and behavioural considerations that help determine a firm’s investment strategy, and which may help a firm to capitalize on the structure of its relationship with fund providers. Such considerations may critically determine a firm’s performance, if not its ultimate fate.

INTRODUCTION

This paper differentiates between two principal types of venture capital firms: captives and independents. “Captive” venture capital firms are those that have been established by financial institutions (e.g. pension funds, insurance companies, merchant banks or clearing banks), and, in turn, receive their capital from these parent firms. Despite their dependence on their parent institutions, however, captives typically have considerable operating autonomy.

On the other hand, “independent” venture capital firms are not associated with a parent organization. In other words, they are burdened with the onerous task of having to

26For further information see http://www.ace-net.org.
raise capital from a variety of outside sources, primarily institutions (figure 1). Frequently, independents are formed and owned by managers of established venture capital firms that have spun off. A common strategy employed by these firms has been to set a certain pre-specified date for liquidation, usually seven to ten years from the firm’s inception. Of late, however, there has been a trend toward immediate dissemination of proceeds from investment distributions (Bank of England 1990, Wright and Robbie 1996). We will suggest that this type of strategic change is crucial to understanding the role of the source of equity capital in motivating a firm’s investment activities.

This study is comprised of four main sections. The first puts forth and clarifies the relevant literature and the theoretical context within which the data were collected. The second more specifically scrutinizes the position of the “independents,” studying more closely the investment behaviours that have contributed to their greater market prominence. The third is devoted to the methodology that was used to collect the data, and presents the basic results of our analyses. The last section will analyse the data in light of the evolving relationship between independents and their outside sources of equity capital.

THE INFLUENCE OF A VENTURE CAPITALIST’S SOURCE OF FUNDS

As the venture capital markets in the UK and the US become more competitive, obtaining funds with which to establish a new venture capital (VC) fund is becoming a more serious concern, and gaining (and keeping) funding from outside sources has become more difficult in recent years, especially due to the increase in the number of
independent VC firms. These VCs raise money in the competitive outside environment from pension funds, corporations and individuals, rather than receiving an endowment from a parent company, as their captive venture capital firm counterpart might. Independent VC firms have become a more significant part of the VC community, from around 30% of VC funds in the UK in the early 1980s to 54% of new funds invested in recent years (Martine 1989, Murray 1995a, Wright and Robbie 1996, Robbie et al., 1997). Along with this increase, the semi-captive firm, a hybrid of the two types, has also become more common. Due to such changes in the UK venture capital community, and the increasing popularity of independents, it has been suggested that the structural change may also affect, no matter how slightly, the behaviour and preferences of the VC industry as a whole. Certainly, any developments witnessed may give some indication of the commonalities we might expect to see in the VC industry in the future.

To gain an indication of what effect the influx of independent VC firms may possibly have on the overall VC investment climate, this study uses new empirical data to compare the investment preferences and behaviours of independent and captive VC firms in the UK. While VCs have started to gravitate away from earlier stage deals, which may need “venture” capital the most, this study will focus more on the impacts on the early-stage end of the venture capital market. Since many of these firms are subsidiaries of older US VC firms and VCs in the UK generally look to the more developed US VC market for guidance, we hope that some of these findings will also have some application to the US market.

**Captive vs Independent Funds**

In both the UK and US, VC firms are composed primarily of two different types, captives and independents, discernible based upon the source of their funding. “Captives” are VC firms which have been established by financial institutions (pension funds, insurance companies, merchant banks, or clearing banks) and receive their funding from these parent institutions, although they have considerable operating autonomy (Martin 1989, Bank of England 1990, Mason and Harrison 1991). These VC funds tend to be open-ended and the amount they are allocated for investment purposes reflects the overall strategy of the parent institution (Bank of England 1990).

“Independents,” in contrast, are VC firms which are not associated with a parent organization and raise capital from various outside sources, usually institutional sources (Martin 1989). They are normally formed and owned by management who may have spun off from established VC firms. These VC firms tend to set up funds of predetermined size and investment strategy, and draw down committed funds as investment opportunities arise. They attempt to liquidate these funds by a pre-specified date, usually 7–10 years from inception, although there has been a trend towards immediate dissemination of proceeds from investment distributions (Bank of England 1990, Wright and Robbie 1996). VCs in independent firms are remunerated from both annual management fees and a portion of the fund’s realized profits (Bank of England 1990) and so “may be more committed than captives to generating a return for investors through realizing a capital gain” (Wright and Robbie 1996: 156) rather than focusing more on an income stream from investments as captives tend to do. To do this, independents may place greater emphasis on earlier stage investments, while captives may prefer management buyouts and buyins (Wright and Robbie 1996). However, one VC from an independent VC fund noted:

The stage that we prefer to invest in really depends on the life of the fund. In the early years of a new fund, we will consider many more early stage invest-
ments than later on. A lot of captives don’t have these problems with the life of the fund since they have a regular flow of funds anyway, so they are less concerned with exiting within a defined time period. They obviously set criteria, but they don’t have to exit all the investments by the end of the fund.

In the UK VC market independents now compose the majority of VC firms and their numbers appear to be growing (Murray, 1995a, Wright and Robbie 1996, Robbie et al. 1997). Yet these independent VCs have for the last few years experienced more difficulty in obtaining funds from outside investors, due to increased competition in the VC market, greater fund provider concern from liquid investments, and reduced foreign investment (Bank of England 1990, 1996, Murray 1995a, 1995b). Whether these recent pressures and the structure of the independent VC firm might account for slightly different preferences and behaviours from their captive counterparts will be the focus of this paper.

**Reputation of the VC Firm**

Venture capital funds must be raised competitively and the primary way for a VC firm to win funding over its competitors is to have a better reputation (Norton 1995). Reputation depends on many aspects of the firm and is the aggregate culmination of many small procedures, conduct, and performance levels which the VC firm maintains. By demonstrating that the top US VCs were perceived to add more value than other VCs, Rosenstein et al. (1990) found that reputation and performance go hand in hand. Thus, with a better reputation than competitors, a VC can raise more total funds and so earn greater annual management fees, which average around 3% of the raised funds. One VC stated, “It doesn’t take a genius to figure out that a 5% return on a $100 million is better than 20% on $10 million.” (Sapienza et al. 1996: 466–467) The size of a particular VC is, therefore, often a function of its past investment success and reputation (Gupta and Sapienza 1988, Zacharakis and Meyer 1995).

However, building a reputation as a VC by investing in early stage ventures, which themselves are high risk, is difficult and risky. These investments, even if they are successful, will not be realized for 7–10 years after the initial investment. Although returns will be less impressive, managing later-stage deals is less risky and will allow VCs to show good returns, and so build up their reputation and attract more funds. Hence, VCs face a trade off between a high-risk, high-return strategy with a long-term horizon, or a low-risk, low-return strategy with a short-term horizon (Norton 1995). It is, thus, not surprising that Gompers (1996) found that young venture capital firms tend to take companies public earlier than older venture capital firms in order to establish a reputation and successfully raise capital for new funds. Since many of the VCs targeted in this study engage in early stage financing (although as a percentage of their funds this will differ per VC), many of them are clearly engaging in a high-risk strategy, which makes signalling responsible behavior even more vital for building a good reputation.

But even if a VC has a good reputation, easing up on the rules and procedures which initially rendered it a strong reputation is unwise. Since the venture capital community is small and networked, reputation effects echo loudly, and can easily damage that carefully built reputation and may offer new opportunities to a large number of potential replacements in the market (Sapienza and Korsgaard 1996, Cable and Shane 1997). Not surprisingly, most venture capitalists interviewed were careful to protect their reputation. When responding to the question “Looking back on your investment, would you have done anything differently?” not one VC admitted that they could have improved upon what they had done.
QUALIFICATIONS OF VENTURE CAPITALISTS

Another way for VCs to signal competence is to hire individuals for the team who have excellent qualifications and experience in the industry. This may explain why the prospectuses of most venture capital funds list the education levels and industry experience of all their venture capitalists. The fact that so many of them have MBAs from top schools is surely no coincidence. In fact, fund providers almost always want to see the qualifications of the general partners of the VC before they invest (Fried and Hisrich, 1989). Good qualifications are yet another performance substitute that VCs (and other firms) use to reduce the asymmetries of information and perceived agency risks for their fund providers.

UP-FRONT RULES

Since portfolio returns will not be realized by the VC for sometimes up to 10 years, and thus observation of outcomes by fund providers cannot be effectively employed as a means of reducing agency risks, the agreement between the VC and the fund providers is highly complex. To reduce future asymmetries of information and gain financing from fund providers, VCs may establish up-front rules which they will agree to follow in managing the fund providers’ money and may even advertise these in their publicity material. In a way, these are self-formulated behavior-based control mechanisms that VCs employ to ensure to their fund providers (ex ante investment) their competent behaviour (ex post investment). One manager summed this up: “venture capitalists invest someone else’s money, so they have to work to criteria they have promised their subscribers they are going to work to.”

Thus, up-front rules (or promises) translate into bureaucratic rules which promote internal uniformity. This uniform corporate culture, in turn, furthers the reputation of the firm (Kreps, 1991). One VC stated that these rules were vital:

Venture capitalists are investing money on behalf of pension funds, we get our money by raising funds. They don’t want us goofing off and having fun. We are not here to enjoy ourselves or satisfy our egos, we are there to make capital gains to benefit pension funds. And that sort of constrains what we do.

PROCEDURES AND DOCUMENTATION OF INVESTMENTS

To further signal that they behave in a most competent manner, VCs carefully follow procedures (often emanating from the aforementioned up-front rules) and meticulously document decisions to show that they took every care in picking the best investments. This and other signals of VC competence are shown in figure 2.

In a pioneering study, Sahlman (1990) identified a number of procedural mechanisms that VCs and fund providers employ to reduce agency cost concerns. These included: the specific prohibition of certain acts by the venture capital firm which would cause conflicts of interest, mechanisms to ensure gains are distributed to investors, expenditure of resources to monitor the VC firm, and regular furnishing of specific information to the funds providers by the VC firm. Following such careful procedures in picking investments also aim to limit a VC’s accountability if the investments fail to realize an adequate return.
In addition, the documentation of decisions is now required by the UK’s Financial Services Act of 1986 and enforced by IMRO (Investment Management Regulatory Organization), a regulatory group for venture capitalists. This ensures that venture capitalists keep accurate records from the time leading up to each of their investment decisions and allows fund providers to check that proper due diligence was conducted. One VC stated:

IMRO makes sure that you are running a proper show. I don’t think that they are too concerned about the quality of the decision, but the fact that every decision is documented. Everything we do has to be properly recorded and we need proper board minutes for every decision that is reached.

**Increased Power of Fund Providers in Recent Years**

The importance of the ways in which VCs behave to reduce asymmetries of information for fund providers has increased in recent years as the marketplace in which VCs try to raise money has become more competitive, both in the US and the UK (Sapienza 1992, Duggins 1993, Murray, 1995a, Robbie et al. 1997). Indeed, this study found that VCs
believed that they had, on average, 8.1 (median: 5) direct VC competitors in their sector. This has made it even more imperative (especially for independent VCs) to market themselves favourably to suppliers of finance, and to use qualified employees, up-front rules, and thorough procedures in the investment process so that fund providers can more easily monitor them, and so that they can signal their high level of competence.

A number of factors have contributed to this increased power of the fund providers while also forcing them to monitor their VCs more closely. First, increased transparency of returns has increased the ability to benchmark the performance of VC firms (Robbie et al. 1997). In fact, fund providers have become skeptical that the industry can pay the price it has promised for the supply of money, creating a huge credibility gap between VCs and fund providers. This has forced many fund providers to “turn off the tap,” as figure 3 shows (Timmons and Sapienza 1992, Duggins 1993). The extent of the problem is evident in a British Venture Capital Association (BVCA) survey response in which 74% of respondents agreed with the statement that “UK venture capitalists had oversold the potential returns of their industry to institutional investors” (Murray 1995a).

Second, the venture capital industry is increasingly driven by the requirements of institutional fund providers who are under mounting pressure to achieve better than average short-term results. Since these fund managers often only have a 3–4 year job horizon, they often eschew a longer term view. Fund managers may thus prefer more liquid investments in traded securities, rather than early stage venture investments in ten year funds (Murray 1995b, Bank of England 1996). Third, the rapid internationalization of the venture capital market has brought an influx of domestic and foreign competitors. Furthermore, alternative sources of finance for entrepreneurs (such as business angels and strategic alliances) and the increasing sophistication of entrepreneurs has eroded venture capital returns. Both these factors have increased competition for the supply of fund provider’s capital and for high-quality entrepreneurial investments in
markets already at or past saturation (Sapienza 1992, Sapienza et al. 1996). Fourth, fund providers are now also being advised by organizations known as “gatekeepers,” who determine which venture capitalists should be supplied (Robbie et al. 1997), further increasing the pressure on VCs. Fifth, there is a trend toward making a smaller number of investments involving larger amounts. This allows fund providers to focus on fewer relationships, but increases their need to monitor VCs more closely (Robbie et al. 1997). Lastly, the requirement for fund providers to develop a coherent investment strategy has increased the need for more non-standard information from VCs.

VCs have responded to these increasing pressures in a number of ways. First, they have increased their information flow to funds providers by enhancing their communication and reporting approaches. This has allowed them to provide early warning signals about impending problems and to give interim rates of return and final payout predictions (Bank of England 1990, Robbie et al. 1997). Currently, VC firms provide about four to six pieces of information to fund providers per year, such as annual reports, semi-annual reports, quarterly reports, semi-annual portfolio evaluations and an annual presentation/visit, and there is a shift away from annual and semi-annual portfolio valuations to more frequent ones (Robbie et al. 1997). Second, as the bargaining power moves to the fund providers, the management fees of the VC are coming under increasing pressure (Murray 1995a). Front-end fees (up to 2-3% of committed funds) are thus being eliminated (Bank of England 1990). Third, VCs have started to place greater emphasis on quicker exits and have, therefore, increased their investments in management buy-outs (Bank of England 1990). Fourth, more VCs are beginning to incorporate pre-set performance targets and can stipulate minimum returns to their investors. Many also require capital repayment from entrepreneurs upon realization of individual investments. Fifth, hoping to differentiate themselves in the marketplace, VCs have increasingly started to promote an image of being more aware and responsive to the needs of fund providers (Murray 1995a, Robbie et al. 1997).

The competitive pressures in the venture capital market have had significant implications. Funds are now no longer available to VCs without a proven track record and as the industry stops growing rapidly, firms can only expand by taking market share from each other (Bank of England 1990, Duggins 1993).

**INDEPENDENTS VERSUS CAPTIVES**

Although both independents and captives are obligated to produce returns for their fund providers, the former is now less assured of a future stream of committed funds and has more pressure to please its fund providers, the majority of which are outside investors. Woolfman (1993) found that all the captive VCs in his response sample claimed to have unlimited access to finance. Due to these structural differences, one might hypothesize that independents may behave in a somewhat more thorough manner in the investment process since there is more pressure on them to signal competence. Indeed, Robbie et al. (1997) found that venture capital fund provision (especially to captive VC firms) is usually a relatively insignificant part of the investment portfolio of institutional fund providers (i.e. pension funds and insurance companies), and so these fund providers may tend to adopt a slightly more relaxed approach to monitoring their captive VC firm(s). This implies that captives have less agency pressure and less incentive to overtly signal competence in the investment process. To test this, our study hypothesizes that independent VCs will behave more competently and take greater care making and monitoring their investments than their captive VC counterparts, so as to signal their responsible investment skills to their fund providers.
METHOD

This study utilized an extensive review of the existing academic literature, 15 personal interviews and 92 questionnaire responses from venture capitalists in the UK. The literature was used to identify the important issues and investment criteria which could be applied in the interview process. This, in turn, helped us formulate the questionnaire.

To obtain a representative sample of VCs in the UK, we drew upon the comprehensive listings in *The Venture Capital Report Guide to Venture Capital in the UK and Europe*. We then randomly chose a group of 15 venture capitalists that had participated in early-stage deals and interviewed each at his place of employment for about 60–90 minutes.

After extensive pilot testing of the questionnaire, 64 (around 60%) of the 108 VC firms listed in the Guide (those who had taken part in early-stage deals) were sent a postal questionnaire. All in all, 81 different VC firms were contacted, including the many regional offices of 3i, (the UK's largest VC firm), with about 2–3 VCs per firm being sent the questionnaire.

Due to the confidential nature of VC investments, the time-consuming nature of survey instruments for respondents and the expense of conducting large-scale research, Brophy and Shulman (1992) state, “financial research on entrepreneurial firms has traditionally used small sample sizes and related methodologies, producing for the most part clinical studies on entrepreneurial finance.” (p. 67) However, this study was fortunate to receive a response rate of 58.8%, with 113 questionnaire returns, of which 92 were usable.

To determine whether the source of funds affected the investment processes of VCs, the questionnaire returns were separated into “captive” and “independent” groupings based on the percentage of outside investors each claimed to have in its fund. In doing this, extensive data were obtained from 33 captive and 59 independent firms, with average levels of outside ownership in the fund of 1.81% and 96.98% respectively. Similar to the majority of the independent VC firms in the UK, 64% of the responses in our sample were also independents. Since all the VC firms that claimed to have made some early-stage investments (as opposed to those which rely primarily on follow-on investments and MBOs) were contacted in this study, it seems reasonable to conclude that the sample is representative of these VCs who invest at the early end of the investment spectrum.

It may also be important to note that, with its sample size of 92 VCs, this study may be one of the largest academic VC-targeted research studies conducted in the UK (excluding the annual aggregate data collection by the British Venture Capital Association (BVCA)). Indeed, given that the VC investments were almost all early-stage ones, their combined investment total of £112.5M represents almost 70% of the total investments VCs made in early-stage firms over these 2 years on record (Bank of England 1996).

RESULTS

As was hypothesized, the empirical results show that, compared to captives, independent VC firms claim to follow those investment behaviours and preferences which can be seen and used to signal competence to their fund providers to a greater degree than captive VCs. Thus independent VCs conduct somewhat more due diligence, are more attracted to investments with high expected financial returns, invest more per deal, gain more contractual control, and claim to monitor their investments more, possibly because each independent VC is only personally responsible for 6.82 investments, on average, compared to the 16.9 for the captive VC. These results are documented in table 1.
<table>
<thead>
<tr>
<th>TABLE 1</th>
<th>Mean Differences between Captive and Independent VCs</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Captive VC Mean (N=33)</td>
</tr>
<tr>
<td>Due diligence process</td>
<td></td>
</tr>
<tr>
<td>Size of firms funded (full corporate value)</td>
<td>£2.12M</td>
</tr>
<tr>
<td>Sector research conducted by investor*</td>
<td>1.75</td>
</tr>
<tr>
<td>Cost of due diligence</td>
<td>£5,354</td>
</tr>
<tr>
<td>Length of negotiations (wks)</td>
<td>4.76</td>
</tr>
<tr>
<td>Number of independent references taken on the entrepreneur</td>
<td>3.13</td>
</tr>
<tr>
<td>Investment criteria*</td>
<td></td>
</tr>
<tr>
<td>Size of the investment</td>
<td>3.75</td>
</tr>
<tr>
<td>Perceived financial rewards</td>
<td>1.72</td>
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<tr>
<td>Niche market</td>
<td>1.94</td>
</tr>
<tr>
<td>Expected rate of return</td>
<td>2.00</td>
</tr>
<tr>
<td>Investor understands business</td>
<td>2.84</td>
</tr>
<tr>
<td>Negotiations and investment</td>
<td></td>
</tr>
<tr>
<td>Size of investment</td>
<td>£450K</td>
</tr>
<tr>
<td>Investor's initial equity %</td>
<td>28.28%</td>
</tr>
<tr>
<td>Entrepreneur's equity %</td>
<td>55.95%</td>
</tr>
<tr>
<td>Transaction costs</td>
<td>£20.8</td>
</tr>
<tr>
<td>Number of entrepreneurs the investor has replaced (as a % of investments made)</td>
<td>12.58%</td>
</tr>
<tr>
<td>Post-investment monitoring Level of monitoring*</td>
<td>2.67</td>
</tr>
<tr>
<td>Number of ventures the VC personally monitors</td>
<td>9</td>
</tr>
<tr>
<td>Miscellaneous</td>
<td></td>
</tr>
<tr>
<td>% of outside investors in the VC fund</td>
<td>31%</td>
</tr>
</tbody>
</table>

*These variables were rated on a 4 point likert scale (1=extensive, 4=none)
*These criteria were rated on a 5 point likert scale (1=very important, 5=not important)
*This criteria was rated on a 4 point likert scale (1=very important, 5=not important)
*Significance is based on two-tailed tests
*Note: S/D=Standard Deviation

To provide further support to these univariate statistical analyses, logistic regressions were conducted in the hopes of gaining further multivariate empirical support for the main hypothesis. In particular, a logistic regression (i.e. logit model) analysed the data to determine which variables can best be used to classify investors as independent or captive VCs. Using the raw data for these two types of VC firms, the resulting logistic model, which has a prediction accuracy of 75.56%, reads:

\[ Z = 3.04 - 0.6826X_1 - 0.087X_2 \]

where the variables in order of greatest predictive power are:

\[ X_1 = \text{The degree to which the VC actively monitors (hands-on) his/her investments} \]
\[ X_2 = \text{The number of firm investments that each VC personally manages/monitors for the venture capital firm}. \]
These multivariate findings provide further support that independent VC firms do indeed pay more attention to personally monitoring their investments (than do captive VC firms) possibly to signal to their external fund providers that they have invested their allocated funds wisely and that they are monitoring their investments with the utmost care. Clearly, just these two variable, both central to the level of personal (and overt) involvement VCs have in their investments, are able to accurately account for about three-quarters of the difference between the two classes of VC investor.

**DISCUSSION**

The empirical results presented appear to support the proposition that due to their greater concentration of external fund providers (and thus potentially greater agency pressures), independent VCs are slightly more thorough in the investment process than are captive VCs, who may have slightly less agency pressure to overtly show competent investment behaviour.

The VC literature renders some support to this study’s findings. The independent VC’s greater concern for high rates of return is endorsed by Wright and Robbie (1996), while it has also been found that independents tend to have higher target rates of return than captives (Wright and Robbie 1996, Robbie et al. 1997). However, support for the due diligence differences is more ambiguous. Wright and Robbie (1996) found that, “Independents place significantly greater emphasis than captives on more detailed specific sources of information . . . Captives place relatively more emphasis on such due diligence (own market evaluation) than independents.” (p. 166) Lastly, although past research has shown that independents may have more pressure to exit investments sooner (Sandberg et al. 1987, Wright and Robbie 1996) and that captives may find the entrepreneur’s track record more important (Wright and Robbie 1996), these differences were not supported in the quantitative results of this research study.

Thus, possibly due to different levels of agency pressures (from their differing concentrations of outside fund providers), independent and captive VCs vary somewhat throughout their investment processes, with independents conducting more due diligence, having greater concern for expected rates of return, gaining more contractual control, and claiming to conduct slightly more post-investment monitoring of their investments. Although these new findings will need to be explored further and in greater depth in future studies, this study’s findings have themselves signalled that the influence of a venture capital firm’s source of funds is a factor with some potential influence within the VC firm.

**CONCLUSION**

This study has attempted to highlight the heterogeneity which exists among venture capital firms. Using the theory of agency risk as a guide, empirical results were collected which lend support to the hypothesized notion that a venture capital firm’s source of funds may have some degree of influence over the operations of a VC firm. This may certainly be a finding of some academic importance since the role of the fund provider is rarely discussed in the academic VC literature and is not always considered as a possible influence on empirical results. Reducing agency costs for their financial suppliers is a very important task for VC firms (particularly independent VC firms), and is imperative for them to keep their financial lifelines. Additionally, it is important to recognize that this obligation has potential ramifications on all the behaviours and activities within the VC firm, and so potentially impacts their investment behaviours and preferences.
This in turn may have some degree of influence on the outside entrepreneurial funding environment.

**DISCUSSION QUESTIONS**

1. Summarize the key points in this article in relation to the chapter topic. Be specific in the analysis that you present.
2. Describe or outline the flow of venture capital in an independent firm.
3. What are captive versus independent funds?
4. Discuss the increased power of fund providers in recent years.
5. Relate the results of this study to understanding the challenge of venture capital funding today.

**ACKNOWLEDGEMENTS**

We extend our sincere appreciation to Colin Mayer, Keith Grint, Kristine Eschner, William E. Wetzel and Tim Jenkinson for their assistance and input on this study. This research was largely funded by the Division of Research at the Graduate School of Business Administration, Harvard University and a grant from the British Venture Capital Association’s Tony Lorenz Memorial Trust Fund.

**REFERENCES**


As Phil Hogan lifted the final pages of his business plan out of his printer, he looked at the clock. It was almost midnight, which meant that he had about seven hours to get ready for another day at work.

But the idea of going to his job was not what was keeping him awake at this hour. No, it was the idea of owning his own business that invigorated him this night, as it had many nights, for many years.

It had started with a newspaper route—and the wish to be independent, make some money, call the shots. At age 12, he had sketched out a time line that included business ownership at age 30.

That didn’t happen, of course. But now, at age 36, he was a CPA with a lot of valuable experience behind him, and he was ready. For the last five years, he had been a senior operations auditor, then a senior financial analyst, and now a marketing representative for Pfizer Laboratories. Before that he had been a senior internal auditor for McDonald’s, and had worked for an accounting firm.

Lately, he had begun to think that if he was ever going to pull himself out of the corporate world, it would have to be now.

Now, stepping over the stacks of Inc. and Entrepreneur magazines on the floor by this desk, Phil took a moment to think about how the last year had gone:

January 1995: Contacted friends, business associates, and acquaintances to tell them he was interested in purchasing a small business that:

• had a net income of $50,000/year for the last five years,
• was located in the South,
• was a retail business,
• had a owner who was selling because of retirement, illness, or death.

March 1995: A former college roommate called to tell him about Jerry’s Famous Frozen Desserts, three upscale frozen dessert stores that meet his criteria. Called the owner, Robert Hicks, to request more information. Received a letter from Mr. Hicks’ accountant stating that before he shared this information, he wanted to see financial statements which verified Phil’s financial capacity to purchase the company.

April 1995: Contacted friends to ask if this was the proper procedure. They said it was. Began to look for a potential investor. Started to work on a business plan.

June 1995: A friend arranged a lunch with a potential investor, Terry Dunleavy, who owned 12 businesses, one of which invested in small businesses. After reading Phil’s (unfinished) business plan, Mr. Dunleavy expressed an interest in investing, and agreed to provide a copy of his financial statements to send to Robert Hicks.

July 1995: Received the past four years of Jerry’s financial statements.

Now Phil picked up those statements to look at them again. (See Exhibits 1 and 2).
### EXHIBIT 1

<table>
<thead>
<tr>
<th></th>
<th>1991</th>
<th>% Sales</th>
<th>1992</th>
<th>% Sales</th>
<th>1993</th>
<th>% Sales</th>
<th>1994</th>
<th>% Sales</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>$2,100</td>
<td>100%</td>
<td>$2,331</td>
<td>100%</td>
<td>$2,611</td>
<td>100%</td>
<td>$2,023</td>
<td>100%</td>
</tr>
<tr>
<td>Cost of Goods Sold:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Food and Supplies</td>
<td>336</td>
<td>16%</td>
<td>396</td>
<td>17%</td>
<td>444</td>
<td>17%</td>
<td>445</td>
<td>22%</td>
</tr>
<tr>
<td>Direct Labor</td>
<td>179</td>
<td>9%</td>
<td>186</td>
<td>8%</td>
<td>183</td>
<td>7%</td>
<td>141</td>
<td>7%</td>
</tr>
<tr>
<td>Spolilage</td>
<td>11</td>
<td>1%</td>
<td>12</td>
<td>1%</td>
<td>13</td>
<td>1%</td>
<td>70</td>
<td>3%</td>
</tr>
<tr>
<td>Overhead</td>
<td>357</td>
<td>17%</td>
<td>373</td>
<td>16%</td>
<td>418</td>
<td>16%</td>
<td>394</td>
<td>17%</td>
</tr>
<tr>
<td>Gross Profit</td>
<td>882</td>
<td>42%</td>
<td>967</td>
<td>42%</td>
<td>1,057</td>
<td>41%</td>
<td>980</td>
<td>48%</td>
</tr>
<tr>
<td>Operating Expenses:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Depreciation</td>
<td>63</td>
<td>3%</td>
<td>70</td>
<td>3%</td>
<td>78</td>
<td>3%</td>
<td>61</td>
<td>3%</td>
</tr>
<tr>
<td>Administrative</td>
<td>147</td>
<td>7%</td>
<td>186</td>
<td>8%</td>
<td>209</td>
<td>7%</td>
<td>162</td>
<td>8%</td>
</tr>
<tr>
<td>Advertising</td>
<td>74</td>
<td>4%</td>
<td>140</td>
<td>6%</td>
<td>165</td>
<td>6%</td>
<td>101</td>
<td>5%</td>
</tr>
<tr>
<td>General</td>
<td>63</td>
<td>3%</td>
<td>70</td>
<td>3%</td>
<td>78</td>
<td>3%</td>
<td>61</td>
<td>3%</td>
</tr>
<tr>
<td>Total Operating Expenses</td>
<td>882</td>
<td>42%</td>
<td>967</td>
<td>42%</td>
<td>1,057</td>
<td>41%</td>
<td>980</td>
<td>48%</td>
</tr>
<tr>
<td>Income before Taxes</td>
<td>815</td>
<td>39%</td>
<td>897</td>
<td>39%</td>
<td>980</td>
<td>39%</td>
<td>659</td>
<td>33%</td>
</tr>
<tr>
<td>Taxes</td>
<td>261</td>
<td>12%</td>
<td>269</td>
<td>12%</td>
<td>309</td>
<td>12%</td>
<td>236</td>
<td>12%</td>
</tr>
<tr>
<td>Net Income</td>
<td>$610</td>
<td>29%</td>
<td>$627</td>
<td>27%</td>
<td>$722</td>
<td>28%</td>
<td>$423</td>
<td>21%</td>
</tr>
</tbody>
</table>

### EXHIBIT 2
Jerry's Famous Frozen Desserts Consolidated Balance Sheet for the Year Ended December 31, 1994 (in 000's)

<table>
<thead>
<tr>
<th>Assets</th>
<th>12/31/91</th>
<th>% Total Assets</th>
<th>12/31/92</th>
<th>% Total Assets</th>
<th>12/31/93</th>
<th>% Total Assets</th>
<th>12/31/94</th>
<th>% Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cash</td>
<td>$125</td>
<td>9%</td>
<td>$200</td>
<td>11%</td>
<td>$240</td>
<td>12%</td>
<td>$125</td>
<td>5%</td>
</tr>
<tr>
<td>Inventory</td>
<td>45</td>
<td>3%</td>
<td>45</td>
<td>3%</td>
<td>50</td>
<td>2%</td>
<td>120</td>
<td>5%</td>
</tr>
<tr>
<td>Property &amp; Equipment</td>
<td>1,450</td>
<td>11%</td>
<td>1,400</td>
<td>8%</td>
<td>1,600</td>
<td>8%</td>
<td>1,925</td>
<td>8%</td>
</tr>
<tr>
<td>Other</td>
<td>356</td>
<td>25%</td>
<td>100</td>
<td>6%</td>
<td>125</td>
<td>6%</td>
<td>125</td>
<td>5%</td>
</tr>
<tr>
<td>Total Assets</td>
<td>$1,400</td>
<td>100%</td>
<td>$1,795</td>
<td>100%</td>
<td>$2,015</td>
<td>100%</td>
<td>$2,295</td>
<td>100%</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Liabilities &amp; Net Worth</th>
<th>12/31/91</th>
<th>% Total Assets</th>
<th>12/31/92</th>
<th>% Total Assets</th>
<th>12/31/93</th>
<th>% Total Assets</th>
<th>12/31/94</th>
<th>% Total Assets</th>
</tr>
</thead>
<tbody>
<tr>
<td>Accounts Payable</td>
<td>$35</td>
<td>3%</td>
<td>$45</td>
<td>3%</td>
<td>$50</td>
<td>2%</td>
<td>$90</td>
<td>4%</td>
</tr>
<tr>
<td>Long-Term Debt</td>
<td>225</td>
<td>16%</td>
<td>350</td>
<td>19%</td>
<td>225</td>
<td>11%</td>
<td>250</td>
<td>11%</td>
</tr>
<tr>
<td>Letter-of-Credit</td>
<td>125</td>
<td>9%</td>
<td>100</td>
<td>6%</td>
<td>85</td>
<td>4%</td>
<td>75</td>
<td>3%</td>
</tr>
<tr>
<td>Deferred Taxes</td>
<td>20</td>
<td>1%</td>
<td>50</td>
<td>3%</td>
<td>50</td>
<td>2%</td>
<td>20</td>
<td>1%</td>
</tr>
<tr>
<td>Taxes</td>
<td>405</td>
<td>29%</td>
<td>545</td>
<td>30%</td>
<td>410</td>
<td>20%</td>
<td>435</td>
<td>19%</td>
</tr>
<tr>
<td>Net Worth</td>
<td>995</td>
<td>71%</td>
<td>1,250</td>
<td>70%</td>
<td>1,605</td>
<td>80%</td>
<td>1,860</td>
<td>81%</td>
</tr>
<tr>
<td>Liabilities &amp; Net Worth</td>
<td>$1,400</td>
<td>100%</td>
<td>$1,795</td>
<td>100%</td>
<td>$2,015</td>
<td>100%</td>
<td>$2,295</td>
<td>100%</td>
</tr>
</tbody>
</table>
Because they looked so good, Phil had visited the company and completed his research for his business plan. With the plan in hand, he knew his next step would be to ask some experts to read the plan, and tell him what they thought of this investment opportunity.

THE BUSINESS PLAN

Robert Hicks and John Roberts, the founders of Jerry’s Famous Frozen Desserts, did 18 months of research before starting their first frozen dessert store. Their initial location was an old deserted gas station in Austin, Texas. They financed their first store with $35,000 in savings, a Small Business Administration-backed loan of $55,000 from Texas Savings and Loan, and capital from their credit cards. In August 1986, they had transformed the gas station into Jerry’s Famous Frozen Desserts. Successful from the beginning, they attributed their profitability to high quality products, giving back to the community, and such forms of advertising as word of mouth, radio stations, newspaper ads, and free press from business publications. As their stores increased in popularity, they expanded to three locations in the Austin area.

Jerry’s sells high quality, super-premium regular and low-fat ice cream. Their upscale products include sundaes, malts, shakes, cones, and soft-serve. They also sell a limited number of products (e.g., pints of ice cream) for the take-home market. The best-selling products are soft-serve French silk and chocolate chip cookie dough. Jerry’s products are more likely to have a chocolate than a fruit base. Their market research indicates the typical customer is between 24–45 years of age.

Several factors have contributed to Jerry’s success. Establishing itself as the first upscale frozen dessert store in the Austin market in 1985 has given Jerry’s the advantage of brand name recognition and being first to market. People recognize the name Jerry’s Famous Frozen Desserts. Others have tried to overtake their lead in the market, but they have failed. Haagen-Dazs opened a store on University Boulevard two years ago, only to have it fail. Another regional chain out of Dallas, called Candee’s Frozen Specialties, also failed after one year.

Competitive pressures from other upscale, retail frozen dessert companies are also limited. The only other national chains which compete with Jerry’s are Haagen-Dazs and Ben & Jerry’s Homemade. Currently, Ben & Jerry’s and Haagen-Dazs are not located in the Austin area.

A major factor contributing to Jerry’s success is superior products. Ingredients in their products are of very high quality. The smooth (soft-serve) nature of Jerry’s products is conducive to the needs of the fastest growing age segment in the U.S., 45–54 years olds. In addition, one of the owners, Robert Hicks, devotes 90 percent of his time to developing new types of products. Finally, Jerry’s has developed an excellent reputation in Austin for its involvement with the community.

The following publicity and awards testify to the success of Jerry’s Famous Frozen Desserts:

- Voted “Best in Business” for the month of June 1994 by In Business magazine.
- Voted “Best Ice Cream in Texas” by Texas Trails magazine, the magazine of life in Texas, in 1993.
- Appeared in a 1990 feature article in the Austin Chronicle, Austin’s weekly newspaper.
Austin Demographics

Jerry’s Famous Frozen Desserts is situated in beautiful Austin, Texas. The Austin area has consistently been ranked by *Money* magazine as one of the “Best Places to Live” in the United States. It is the capital of Texas and home to one of the largest and finest universities in the world, the University of Texas at Austin. Austin is located in Travis County. The 1993 estimated population for Travis County is 383,420 and for the city of Austin is 196,053. Projected increases in population are shown in Table 1. The median estimate for household income in 1993 was $40,000 for Travis County and $36,000 for the City of Austin.

The U.S. Frozen Dessert Industry

Total sales for the frozen dessert industry in 1993 were $10.7 billion, an increase of 5.2 percent over 1992 sales. *Frozen Food Digest* (July 1994), estimates that the sales of frozen desserts will exceed $12.8 billion by 1998, an increase of about 20 percent over 1993 sales. Growth will be in two areas: (1) full-fat products that appeal to indulgent consumers and (2) fat-free products that appeal to consumers’ health and diet concerns.

Currently, 90 percent of U.S. households purchase ice cream, with consumption peaking in the summer. Ice cream is traditionally one of the most popular and profitable desserts in the United States. A survey by *Restaurants and Institutions* in 1993 showed that 40 percent of operators’ menus have hard ice cream, 30 percent offer sundaes, and more than 25 percent offer ice cream specialties.

Industry Structure and Products

The U.S. frozen dairy dessert industry is currently in the mature stage of the industry life-cycle. The market is segmented into the retail (dripping store) sector and the supermarket (take-home) sector. Recent attention has emphasized the supermarket sector where competitors such as Colombo, TCBY, and Swensen’s have entered the market. Profits are becoming harder to sustain in the supermarket sector due to added competitive pressures from new firms entering the market.

Classification of various types of ice cream products is based on the percentage of butterfat and overrun (air content). Typically, higher quality ice creams contain fresh whole products, less air, and as much as 20 percent butterfat. The product segments are:

- **Superpremium ice cream** 16–20 percent butterfat and less than 40 percent overrun. A four-ounce scoop has 260 calories. Examples: Jerry’s Famous Frozen Desserts, Haagen-Dazs, Ben & Jerry’s Homemade, and Frusen Gladje.

- **Premium ice cream** 12–16 percent butterfat and 40–60 percent overrun. A four-ounce scoop has 180 calories. Examples: Breyer’s, Edy’s, and Sealtest.

### Table 1
Projected Population Growth for Austin, Texas

<table>
<thead>
<tr>
<th>Projection</th>
<th>Travis County</th>
<th>% Increase</th>
<th>Austin</th>
<th>% Increase</th>
</tr>
</thead>
<tbody>
<tr>
<td>1980</td>
<td>323,545</td>
<td>13%</td>
<td>170,616</td>
<td>12%</td>
</tr>
<tr>
<td>1990</td>
<td>367,085</td>
<td>13%</td>
<td>190,766</td>
<td>10%</td>
</tr>
<tr>
<td>2000</td>
<td>416,088</td>
<td>9%</td>
<td>209,523</td>
<td>39%</td>
</tr>
<tr>
<td>2010</td>
<td>454,699</td>
<td>7%</td>
<td>292,013</td>
<td>39%</td>
</tr>
<tr>
<td>2020</td>
<td>488,515</td>
<td></td>
<td>NA</td>
<td></td>
</tr>
</tbody>
</table>

Source: Travis County Regional Planning Commission and 1990 Census; figures include University of Texas at Austin students.
Luxury ice cream  Specialty brands, which are the most expensive, like Godiva.
Low calorie/low fat  Contains only 2–7 percent milk fat. Example: ice milk.
Frozen yogurt  Only about 1.7 percent milk fat at 120–125 calories per cup. Examples: TCBY and I Can’t Believe It’s Yogurt.
Soft-serve ice cream  Typically ice milk (3–10 percent butterfat). Children comprise 50 percent of sales in this segment.
Frozen custard  A form of ice cream which has a very high fat content, but not the highest. Example: Various frozen custard stores.

Industry Threats and Trends  The Census Bureau estimates the total U.S. population annual growth rate will slow to a mere .9 percent per year for the remainder of the century (U.S. Department of Commerce, page 34). The fastest-growing age group will be the 45–54 year olds, increasing by 45 percent by the end of the decade. The changing demographics of the U.S. could have a negative effect on the frozen dessert industry. As people increase in age, their taste preferences change. This could drastically affect the sales of frozen dessert companies unless they adapt to the older generation’s needs. Older people still buy dessert items, but they tend to shy away from products full of nuts and candy. To combat this trend, Ben & Jerry’s Homemade has introduced a new line of “smoothie” ice cream. Therefore, Ben & Jerry’s has appealed to the taste buds of the older generation.

Currently, 30 percent of all family households are run by a single parent, of which 80 percent are women. The growing number of single-occupant and single-parent households combined with more working women and increased travel, is fueling a shift in demand towards the away-from-home market for consumer food and beverage spending (U.S. Department of Commerce, pages 16 and 17). This is a promising sign for the frozen dessert industry.

One of the biggest competitive pressures in the immediate future for the dipping store sector will be from supermarkets selling frozen dessert items. As more and more competitors sell through supermarkets, consumers will have a larger base of products to choose from. Furthermore, buying desserts at the store will be more economical. As Bob Vranek, a family man from Charlotte, North Carolina, states “Why would I want to take my four kids to a TCBY store and spend $14 when I can go to the supermarket and buy a half gallon of frozen yogurt for $3.50? What would you do?”

During the 1980s, the U.S. frozen dessert industry saw a redirection towards the health conscious consumer with the introduction of several new products (e.g., low-fat and fat-free products). NutraSweet® was introduced as a substitute to replace sugar. In addition, frozen yogurt, which contains little butterfat, sugar, or cholesterol, has become very popular in the 1980s and 1990s.

The trend in the 1990s is the “split personality” in consumer taste preferences. Consumers want to eat healthy, but they want products to taste rich and creamy. There is an increasing demand for very rich and light products. This has left a shrinking demand for mid-range products. The current trend is towards richer, mix-in, ingredient-packed premium products and lighter, health- and diet-oriented products.

In high demand are low-fat ice creams, with no more than three grams of fat per serving. ConAgra, a major corporation which competes in the grocery segment in the frozen dessert industry, reports there are 978 brands of regular and light ice cream, yogurt, and sherbet in the U.S. marketplace. Their Healthy Choice Premium Low-Fat Ice Cream ranks eighth in dollar sales. Their marketing strategy is the continual development of
new healthy products such as low-fat flavors like Malt Caramel Cone, Cappuccino Chunk, and Black Forest. According to Ken Colnar, director of marketing and sales for ConAgra, “The key to success is you need to give consumers what they want—an ice cream so rich and creamy that they forget it’s low in fat.”

Further evidence of the trend away from ice cream is the frozen yogurt market, which is growing at a 12 percent annual rate (see Exhibit 3). New products are constantly being developed in the frozen yogurt market, including everything from fat-free fruit flavors to brands with chunks of nuts, brownies, and candy. Firms are developing two versions of frozen yogurt: a light line and another oriented towards indulgence. Supermarket consumers will increasingly choose healthier products in the future due to the passage of the Nutrition Labeling and Education Act of 1990, which took effect in May 1993, all products are now required to list calories and fat content on their labels. While the trend in supermarkets is changing, the effect of the Nutrition Labeling and Education Act on the dipping store segment is unknown at this time. The act should not have as significant an effect on the dipping store sector because customers will not have the luxury to examine the calorie and fat content on the dessert containers unless they buy packaged dessert items to go.

**Competition in the U.S. Frozen Dessert Industry** Jerry’s faces tough competition from two sectors—supermarkets and dipping stores.

**Supermarkets**

National competitors: Ben & Jerry’s Homemade, Haagen-Dazs, and Baskin-Robbins.

Integrated Resources: Steve’s Homemade Ice Cream, Swensen’s, and Heidi’s.

Craft General Foods: Sealtest, Breyer’s, Borden, Colombo, Frusen Gladje, and TCBY.

Other competitors: Ben & Jerry’s Homemade, Gelare, Breyer’s, Friendly’s, Dreyer’s/Edy’s, Mayfield’s, Basset’s, Honey Hill Farms, Larry’s, private local grocery brands, and other companies putting out novelty products (Bon Bons, Butterfinger, Dove, Eskimo, Milky Way, Nestle’s Crunch, 3 Musketeers, Snickers).

**Dipping Stores**

National competitors: Ben & Jerry’s Homemade, Haagen-Dazs, TCBY, Baskin-Robbins, Colombo, Frusen Gladje, I Can’t Believe It’s Yogurt, and International Dairy Queen.
Regional competitors: Honey Hill Farms, Swensen’s, Friendly’s, Steve’s Homemade Ice Cream, Breyer’s, and some other chains.

**Competition of Dipping Stores in Austin**  Jerry’s competition from national chains is limited in the Austin area. There are six International Dairy Queens and only one TCBY. There is a large number of local competitors. Currently there are five chocolate Ice Cream & Candy Stores, one Van Jordan’s Ice Cream Co., two Mimi’s Ice Cream Parlors, one Jamie’s Chocolate Shoppe, and a variety of restaurants serving dessert items.

**International Dairy Queen**  Dairy Queen was founded in 1940 in Illinois and expanded by granting territory franchise rights for specific geographical areas. The company’s current name, International Dairy Queen, was formed in 1962. The firm develops and services a system of quick-service restaurants that are franchised by the company to offer hard and soft-serve ice cream, limited menu items, and beverages under Dairy Queen, Brazier, and other trademarks.

The Brazier product line features hamburgers, hot dogs, barbecued fish, and chicken sandwiches, french fried potatoes, and onion rings. The Dairy Queen dairy dessert product lines include cones of various sizes as well as shakes, malts, sundaes, sodas, hardpacked products for home consumption, and specially frozen confections (frozen ice cream cakes and logs). The products are prepared in the stores from the company’s specialty formulated ingredients.

As of August 1993, the company had 6,068 franchised Dairy Queen units in the U.S., Canada, Japan, and several other countries. System-wide sales were over $2.1 billion. Dairy Queen has also diversified into the fast-food industry by acquiring the franchise rights to the following chains: Golden Skillet in 1981; Orange Julius in 1987; and Karmelkorn Shoppes, Inc., which sell popcorn, candy, and other treat items, in 1986.

International Dairy Queen has implemented the “Treat Center” concept. This franchising concept combines Dairy Queen treat items, together with either or both Orange Julius or Karmelkorn menu items, under one storefront within a shopping mall. The concept is based on the economies of leasing and improved sales volumes of the combined products. As of 1993, there were 105 Treat Centers units in the U.S. and in Canada. All were franchised by the company (Piper Jaffray, 1993).

**TCBY**  TCBY is the leading operator and franchisor of soft-serve frozen yogurt stores. Currently, 2,353 TCBY outlets exist in the U.S. and in nine foreign countries. Of these, 1,379 are franchised, 82 are company-owned, and 808 are nontraditional locations (e.g., airports, roadside travel plazas, hospital, schools, and other noncommercial food service locations). TCBY’s revenues come from the sale of frozen yogurt and yogurt products, company-owned yogurt shops, equipment sales, and franchise royalties and sales.

In addition to the sale of various frozen yogurt products, TCBY has been testing new menu items under the theme “Sensible Temptations.” New products such as soups, salads, and sandwiches are available in certain stores which meet criteria (Stephens, Inc., 1994). These sales have helped keep some franchises in business.

TCBY has been accused in the past of opening up too many franchises in remote locations. This has seriously hurt the profitability of some franchises. Furthermore, TCBY’s introduction of a product line in the supermarket sector has boosted its bottom line, but at the expense of some of its franchisees. Some franchisees are complaining about dwindling profits due to the easy and less expensive customer access to TCBY frozen yogurt in the supermarket sector.

**Ben & Jerry’s Homemade: A Potential Entrant**  Ben & Jerry’s currently is not in the Austin area. However, the threat of entry remains very possible over the near future as
Ben & Jerry’s expands its franchise areas. If this were to occur, they would be a main competitor of Jerry’s Famous Frozen Desserts.

Ben & Jerry’s Homemade was founded in 1978 after Bennett R. Cohen, a college dropout, and friend Jerry Greenfield, took a $5 correspondence class on how to make ice cream. Since opening their first ice cream shop in an old empty gas station, Ben & Jerry’s Homemade Inc. has become a leading producer of superpremium ice cream, ice cream novelties, and both low-fat and nonfat frozen yogurt. Sales and net income increased between 1989 and 1993. Net sales have increased from $58 million to $140 million, while net income has increased from $2 million to $7.2 million. Ben & Jerry’s current strategies are:

- **Differentiation** Using the finest, high-quality, all-natural ingredients, they develop ice cream and yogurt products with large chunks of mix-ins. They differentiate themselves from the competition by having superior ingredients and a larger amount of mix-ins.
- **Product development** They have developed several original flavors such as Rainforest Crunch, Chocolate Chip Cookie Dough, Praline Pecan, Chunky Monkey, Wavy Gravy, and Cherry Garcia. They are continually developing new innovative products.
- **Market development** Since their inception, Ben & Jerry’s has targeted two focus groups: (1) a frozen yogurt line oriented towards the health-conscious customer and (2) a “Smooth, No Chunks” line targeting the 35–54 age group. A Ben & Jerry’s spokesperson states that their most popular frozen yogurt flavors are versions of their rich ice cream flavors. Their new smooth no-chunks line is oriented towards older customers who don’t tend to like large pieces of mix-ins in their ice cream.
- **Social causes** Another primary cause for their success is their belief in giving back to society. Ben & Jerry’s founded an organization called Ben & Jerry’s Foundation, Inc., which gives 7.5 percent of their pretax profit to charities. In 1993, they gave away $808,000 in 142 grants to assist with causes like AIDS, homelessness, immigrant rights, environment, and sexual harassment.
- **Geographical expansion** They currently have over 100 franchises located all over the world. In addition, they sell their products in grocery stores throughout the U.S. To solve the problem of competing with their franchises, Ben & Jerry’s sells a limited variety of their products at the same price as franchises.
- **Advertising** In 1994, Ben & Jerry’s launched its first television advertising campaign to promote its new “Smooth, No Chunks!” line.

These strategies have allowed Ben & Jerry’s competitive advantage in the frozen dessert industry. However, Ben & Jerry’s fast growth has caused enormous managerial problems. Their CEO, Jerry Greenfield, recently resigned. They subsequently elected a new CEO. The new CEO will have to provide leadership and a vision to move the company forward. A related issue is executive compensation. In the past they have limited executive compensation to a mere seven times the lowest salary in the company. Recently, Ben & Jerry’s has reluctantly decided to discontinue its policy of capping the highest-paid employee. This is likely to have a negative effect on their corporate culture.

Currently, Ben & Jerry’s holds the number two market position, with 43 percent of the superpremium ice-cream market, compared with 54 percent for Haagen-Dazs. The fourth quarter 1994 was the first time the company had ever lost money following its initial public offering. This is mainly due to their current managerial problems and the recent passage of the Nutrition Labeling and Education Act of 1990. Most of Ben & Jerry’s products tend to have a very high fat content.
Jerry’s Weaknesses, Opportunities, and Threats

**Weaknesses** One of the major weaknesses of Jerry’s Famous Frozen Desserts is their current management. John Roberts, the business-oriented partner, died in 1994. The remaining partner, Robert Hicks, is the creative part of the company. As a result of Hicks’ inexperience, within the last year, turnover at Jerry’s has increased. This is thought to be the primary reason Hicks wants to sell the chain. The final weakness is the lack of products with different types of fruit in them. The menu is limited primarily to chocolate-based products.

**Opportunities** Several opportunities exist for Jerry’s. The most obvious is the huge potential for growth. Jerry’s has a proven, successful concept and product base. They have the potential to grow by opening new corporate stores and/or franchising. Jerry’s also has the potential to grow through nontraditional forms (e.g., selling at kiosk stands, carts, ball games, concerts, and other entertainment venues). Home delivery also offers growth opportunities. Currently, no firm delivers upscale frozen dessert products in the Austin area.

Product development offers another avenue for growth. Jerry’s needs to continually develop new products to differentiate itself from the competition. The potential to take some of these products and sell them in other markets (e.g., supermarkets and restaurants) is enormous.

Another opportunity for Jerry’s is the rising population base of the Austin area. Austin is expected to increase its population by one percent per year until the year 2000 and then by four percent per year from 2000 to 2010. The increase in the number of single-occupant and single-parent households will continue to fuel the trend toward away-from-home meals. In addition, the increasing number of two-income families will allow higher-income people the luxury of going out for dessert.

Since the fastest growing age group is 45–54 year olds, Jerry’s has the opportunity to take advantage of the growth in this population segment by emphasizing the “smooth” aspect of their ice cream products.

**Threats** The major threat to Jerry’s is the mature stage of the industry life cycle with intense competition (from both supermarkets and dripping stores). Other threats are the increasing health consciousness of consumers, the aging population base which will bring a change in people’s eating habits, the slowed population growth in the U.S., and the passage of the Nutrition Labeling and Education Act of 1990.

**Management Team**
Phil has gathered the following key people to be part of his management team following the acquisition. They have the experience and education to grow Jerry’s into a national chain of frozen dessert stores.

**Phil Hogan, CEO/President and Board Member** Mr. Hogan, age 36, holds both a B.S. (Accounting) and M.B.A. (Finance) from the University of Texas at Austin. He is also a CPA. Mr. Hogan brings a wealth of industry experience to Jerry’s. He spent three years as a certified public accountant with Peat, Marwick, Mitchell, & Company in Dallas. This was followed by two years at McDonald’s Corporation, where he was a senior internal auditor responsible for operational and financial audits of franchise restaurants. The audits focused on sales reporting, cash receipts, inventory controls, cash receipt and disbursement controls, and fraud reviews. After McDonald’s, Mr. Hogan spent five years at Pfizer Laboratories in various positions such as senior operations auditor, senior financial analyst, and marketing representative for their alternate site production sales force. Mr. Hogan currently lives in the Houston area.
George Harris, Consultant and Board Member  Mr. Harris, age 38, has both a B.S. and M.B.A. in Business Administration specializing in entrepreneurship and small-business management from Babson College. Mr. Harris has been a successful entrepreneur for the past 15 years. He began his entrepreneurial background by working in his family’s restaurant, and followed with 10 years of other work experience in the restaurant industry. Currently, Mr. Harris owns two very successful restaurants in the Kansas City, Missouri, area.

Dr. John Frank, Consultant and Board Member  Dr. Frank, age 55, holds both a B.S. and an M.B.A. in accounting from San Diego State University. He also has a Ph.D. in Business Administration from the University of Wisconsin–Madison and is a CPA. Dr. Frank is both an entrepreneur and an educator. He has started and grown two successful companies. Dr. Frank is world renowned in the area of entrepreneurship and small-business management. His current title is professor of management at the University of Texas at Austin Graduate School of Business.

Professional Advisers and Services

Accounting  The accounting firm which will be used in the acquisition process is the Austin Accounting Group. They will continue to be the accounting firm used following the acquisition.

Banking and Legal  Mr. Hogan has obtained the services of Doug Brady, an attorney in Austin, to assist with the acquisition process. Legal advice is also being obtained from friends of Hogan’s, Kevin Sizemore and Gordon Goldstrom. Banking services have also been retained from Mike Jones, a branch manager at Southwest Bank in Austin.

Summary of the Company

The company had a successful track record for the past eight years. The owner wanted out due to the death of his partner. Furthermore, even though the U.S. frozen dessert industry was in its mature stage, Jerry’s had created a very profitable niche. One of the major players, Haagen-Dazs failed against Jerry’s. Jerry’s had sustained a strong brand name within Austin. Additionally, Austin is a great part of the country to be in, with its warm weather, lakes, pretty country and apparently unlimited opportunity to grow the chain.

FIELD NOTES

These are the notes made by the consultants who Phil Hogan turned to first. This case is based on an actual business and these notes reflect the first step in a real consulting relationship.

Knowing of our background in this area, Phil Hogan called us when he began to write his business plan. We provided some guidance to him during the writing of the plan, and we helped him sketch plans for the action (see Exhibits 4 and 5).

The next areas for discussion are financing and valuation. We explained to Phil that there are several ways to value companies and structure deals. Robert Hicks had previously stated that he needed at least $175,000/year after taxes. He stated that he would need at least $2 million in cash in order for this to occur.

We shared the following general guidelines on financing with Phil.

Financing Alternatives for Small-Business Acquisitions

Small business acquisitions can be structured through debt, equity, or a combination of both. The following briefly reviews some of these options.
Debt Financing  These are loans obtained for the purchase of a small business. The most popular forms of debt financing are:

- **Savings, friends, family, and credit cards**  Capital is obtained from savings, friends, family, or credit cards.
- **Seller financing**  A portion of the selling price of the business is financed through the seller. Seller financing is sometimes partially structured through a consulting
contract, whereby the seller will continue to work for the company and receive a
yearly salary.

- **Government programs** Federal, state and local government loan programs (e.g., Small Business Administration and local economic development programs) have money available for small-business acquisitions. These interest rates are usually cheaper than bank rates.

- **Commercial banks** Loans that are available from commercial banks. The problem with this source of money is that banks usually require collateral before they will allow you to borrow funds.

- **Mezzanine financing** This form of financing allows a bank to provide a term loan over an intermediate time period (usually 7–10 years) with an option to convert a balloon payment at the end, into some equity ownership.

- **Asset-based lenders (ABLs)** These are companies that lend money based on a percentage of an existing company’s equipment, accounts receivable, inventory, or other assets. They can be found in finance companies or departments of commercial banks.

**Equity Financing** Equity capital is money in exchange for a percentage of ownership in a business. Some of the more popular forms of equity financing are:

- **Private investors** Comprised of family, friends, suppliers, accountants, customers, business associates, business professionals, or attorneys.

- **Venture capital** Money that can be obtained from private venture capital firms, small business investment companies (SBICs), minority enterprise small business investment companies (MESBICs), venture capital subsidiaries of large financial institutions, and industrial corporations. The cost of capital is very high (30–50 percent/year).

- **SBICs** Small business investment companies (SBICs) are privately owned venture capital companies sponsored by the federal government. They provide straight debt or equity financing or a combination of both.

At our next meeting, we plan to discuss financing alternatives in more detail, and we also plan to begin to explore the topic of valuation. We agreed to work with Phil on the topics of financing and valuation. In addition, we suggested that he contact his friends and business acquaintances for advice.

**Discussion Questions**

1. Analyze the business plan as it is presented, and relate it to some of the key points in the chapter concerning assessment.

2. Discuss the alternatives for financing that are presented in the case.

3. Present the financial opportunity to buy this ongoing business. Would this be a viable opportunity for an aspiring entrepreneur such as Phil Hogan?

4. What major questions still exist in your mind after reading this case? What venture assessment principles should be applied to this opportunity?
References


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