Venture Capital 2.0: From Venturing to Partnering

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Contents

Abstract

Against the backdrop of an ever-changing financial landscape sometimes characterized by an abundance of funding and start-up opportunities, but usually characterized by down rounds and decreasing valuations (leading to funding, investment and liquidity gaps), "venture capital" has taken on a new uncertainty and complexity. In this review, we suggest that venture capital should not exclusively — or even primarily — be defined in terms of providing risk capital (and advise) to founder-entrepreneurs. Such an approach to venture capital, which is often described in terms of a "venture capital cycle", seems to represent the conventional wisdom in most recent discussion. According to this perspective, the solution to the funding, investment, and liquidity gaps is for new sources of capital — be they government, corporate or crowd — to step in and provide founder-entrepreneurs with money, capacities and connections that allows them to start, scale, and grow their businesses.

These ingredients are necessary but not sufficient to maximize the economic potential of start-ups. Clearly we need something more. Recently, alternative forms of finance and a new breed of venture capital providers have emerged which focus more on collaborations and the process of building long-term relationships constructed around sharing, mutual trust and respect (partnering) than making money (venturing). Online platforms, such as *AngelList*, play an important role in encouraging these collaborative models. Some investors have labeled this process as "venture capital 2.0". We explore the view that reforms that relax rules and regulations governing initial public offerings should attract new "venture capital 2.0" investors and high volumes of business. However, the growth rates for new segment listings in Europe and the United States have stalled recently, casting doubts on the usefulness

of the of the IPO route for both young firms and investors. We suggest that a renewed focus on private IPOs, followed by a trade-sale or public IPO, is necessary to accommodate the preferences of entrepreneurs and investors.

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Introduction

The recent financial crisis and subsequent economic downturn have taken their toll on banks. This is particularly worrisome for small- and medium-sized enterprises (SMEs), since in most countries, loans are the main source of external finance for these smaller companies. In the United States, for instance, recent studies show that banks' lending capacity shrank between 2008 and 2013, due to higher risk aversion in a time when economic growth had slowed [Federal Reserve Bank of Cleveland, 2013]. As a consequence of the rationing of bank loans and credit, recent empirical work has shown that there is a financing gap for SMEs. A "financing gap" is an information asymmetry problem between lenders and borrowers [Hall and Lerner, 2010]. The European Central Bank [2015] observes that smaller firms face greater perceived and actual constraints than larger firms and that this would play a critical role in the narrowing of available finance options for SMEs. Thus scholars and policymakers are paying greater attention to understanding the financing gaps for segments of the SME sector, especially high technology and fast growing enterprises.

Relative to larger firms, SMEs are well known for being extremely sensitive to external market shocks: severe economic conditions or changes in business regulation. Some of the main causes of higher sensitivity are risks associated with small-scale business, lack of experience, low productivity, local market focus, and a high rate of bankruptcies. The direct consequence of higher sensitivity to external market shocks is limited access to short-term and long-term financing. However, the evidence indicates that, in the presence of increasing unemployment in the period between 2008 and 2013, the share of employment in the SME sector increased relative to that in other sectors in the European Countries [Lopez de Silanes et al., 2015]. Researchers have examined which types of firms are the most important players in net job creation. In the United States, the importance of SMEs for the economy is even greater with young firms or start-ups accounting for about 70% of gross US job growth annually [Haltiwager, 2012]. Furthermore, recent evidence supports the importance of firm dynamics and the reallocation of resources to the fastest growing firms to achieve better economic performance [Acs et al., 2008, Bravo-Biosca, 2010].

Past studies have tried to show that banks' local networks ties and relationships have reduced the uncertainties and mitigated some of the risks of opportunism associated with bank lending to SMEs. This literature has emphasized how enabling environmental initiatives may have actually reduced information asymmetries and transaction costs, which could contribute to an expansion of SME financing [Beck et al., 2014]. Despite its insights, it is difficult to measure the impact of these enabling environmental initiatives, which may depend on parties' confidence in the enforcement of contracts or collateral enforcement actions.

The most obvious and widely recognized solution to alleviate credit rationing is the use of collateral, which gives the SME — with a serious credit problem — an incentive to repay the loan. Yet if collateral is not available, a credit guarantee system for SMEs that offsets the reduced reliability of nonaudited financial statements may improve access to credit as well as improve loan terms [Beck et al., 2010].

Increasingly, policymakers are attempting to increase the flow of funds for SMEs through guarantee schemes or asset-backed securitization. Most governments have invested in a loan guarantee program because they: (1) address the market imperfections that cause credit restrictions to SMEs; and (2) spur innovation in the SME sector. The presence of the guarantee can result in a lower rate paid for the loan. However, the empirical evidence is mixed. We find that a significant portion of the effectiveness of credit guarantee systems results in an increase in firms' outputs and employment [Hancock et al., 2007]. Prior research, such as Zecchini and Venture [2009], shows that they lead to greater amounts of bank loans to firms and to lowering the costs paid by the firm. Moreover, Hancock et al. [2007] find empirical evidence that credit guarantees provided by US Small Business Administration (SBA) have a substantial effect on firm's output and employment, finding also that the guarantees reduced the cyclicality of local bank's SME lending. However, Lelarge et al. [2008] find that guarantee programs might actually induce banks and entrepreneurs to undertake riskier behavior. That said, we also find that founders of high growth companies complain about the "complex terms", "misaligned incentives and an 'overemphasis' on protecting the downside, instead of focusing on the upside" when attracting funds under a guarantee scheme.

A second nonbank focused lending channel is securitization, which involves selling securities linked to pools of loans from different borrowers with correlated underlying assets [Gorton and Metrick, 2012]. The collapse of the European securitization market during the financial crisis has played a key role in the decline in lending volume to SMEs over the last seven years. While efforts to jump-start Europe's securitization markets are continuing along a number of dimensions, ensuring a deep and efficient market is needed before it will be possible to attract banks and new nonbank lenders to securitize. This suggests that some of the barriers that hold back securitization of SME loans at a national level will persist.

In response to the decline of bank funding, alternative sources of finance are needed to provide funding to start-ups and SMEs. To gain a better understanding of the alternatives to bank financing for SMEs and entrepreneurs, we examine a range of "new" external financing providers, including crowdfunding platforms, the new breed of venture capital firms, and corporate venture capitalists. In this review, we assess the likely impact of each of the different financing options available to SMEs and high growth companies. We ask whether they can, with greater network resources, improve the selection of investments and access to follow-on funding in later stages of a start-up's development. It is interesting to see that these new breed of capital providers have introduced "collaborative models" which appear to play an invaluable role in the selection of the right mix of portfolio companies, and can also offer the access to new technologies as well as possible exit opportunities. At the same time, we explore the role of government equity co-investment programs that provide funding and advice through public-private partnerships. Again, our research suggests that as long as these government programs add value to the collaborative venture capital models, they can play an important role in funding innovative projects.

The review proceeds as follows. Section 2 discusses how governments can encourage entrepreneurship and the launch of start-up companies and influence the development of SMEs. Section 3 provides an overview of the traditional venture capital cycle and focuses on the funding, investment, and liquidity gaps in this cycle. An understanding of the gaps is necessary for governments and policymakers to develop well-considered and targeted measures. This section extends this research by investigating the recent trends and developments in the venture capital industry, which arguably create a "new" venture capital cycle. As we will show in Section 4, some of the developments (recently introduced in practice) have proven to be an effective step in bridging the gaps in this cycle. The goal of our analysis is to show that the new breed of "venture capital providers" no longer think of their function as simply providing a source of capital in the expectation of financial return. This section illustrates that the task is to build an open and collaborative relationship with "their" portfolio firms. Some investors have labelled this trend as "venture capital 2.0". Section 5 concludes.

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