

The Journal of **PRIVATE EQUITY**

Strategies and Techniques for Venture Investing

VOLUME 7, NUMBER 1

WINTER 2003

JAMES E. SCHRAGER	Editor
HARRY KATZ	Production Director
MICHELLE WRIGHT	Production Manager
DAVID GOMBAC	Senior Staff Copyeditor
AJANI MALIK	Reprints Manager
<hr/>	
ANNE O'BRIEN	Marketing Director
MICHELLE COX	Marketing Manager
STEFANNY HSU	Assistant Marketing Manager
<hr/>	
TRISHA GORMAN	Advertising Director
DAVE GALAN	Advertising Associate
<hr/>	
ROBERT TONCHUK	Fulfillment Director
VINCENT YESENOSKY	Senior Fulfillment Manager
CHERLY-NINA BONNY	Fulfillment Manager
<hr/>	
DAVID E. ANTIN	Director of Finance and Operations
KAREN LEE	Business Manager
<hr/>	
ALLISON ADAMS	Publisher
CHRIS BROWN	CEO

Everyone is always looking for the next big thing. This is a natural and consistent theme in venture capital investing, when so often the next big thing is defined in technology terms. In private equity buyouts, the next big thing can be described as a wonderful business we discover on the market at a fair price, or a distressed business that we believe we can turn around. Either way, opportunity recognition is at the heart of the investment selection process. This issue we concentrate on ideas about opportunity selection, assessment of entrepreneurial skills, reviews of the role of venture capital in IPOs, and success of various types of IPOs. In addition, we wonder about the concept of outsourcing the strategic competency of due diligence.

Our first piece reviews the intriguing question of whether habitual entrepreneurs differ from novices in their ability to recognize and process opportunities. Through over 750 responses, Ucbasaran, Westhead, Wright, and Binks explore how intensely entrepreneurs research new business ideas. Do experienced or novice entrepreneurs use different sources of information? Does one group spend longer on data acquisition? What about the “development mode” theory—which states that entrepreneurs plan on developing opportunities by getting started in the flow of a business, even when the exact potential of an idea is unknown? Or is it the competing “alertness model” that drives opportunity recognition? These and other questions are addressed in this piece.

On the other side of the opportunity recognition table sits the funding sources. What methods do they use? Is there a standard set of criteria? Two methods are analyzed with an eye toward understanding which method works best. The “espoused criteria” approach examines decisions made on what VCs say are the decisive issues. This approach is contrasted with the “known attributes” presented on the face of the business plan. The outcome is measured by looking at which deals were funded and which were not. Which do you think will win, the stated criteria of the VC, or the facts as presented in the business plan? This article also describes the “New Venture Template” which is a tool used to operationalize the known attributes within each of the over 125 business plans studied.

Going one step further, once we have an entrepreneur with an idea, a funding source that has made the decision to invest, we now need a management team to implement the idea. Solomon,

Fernald, and Dennis studied owners from 160 firms and split their sample into two groups: high growth and non-high growth. They then asked the entrepreneurs in what areas they needed additional study and help. No surprise that among the owners of non-high growth firms the most deficient management skill was increasing sales. Would you think that the same attribute holds for the high growth owners as well? The findings are limited by the small sample size of the high growth firms, but we think you will find them interesting none the less.

After we've found the idea, made the investment, helped our entrepreneur where needed on management tasks, how much has the infusion of venture capital money helped? This is such an interesting question, the next three articles will each address it from a different angle. Reid and Smith intensively study 20 companies, made up of 7 low performing companies and 13 high performers. The aim of the study is to investigate the effect of the pressures and controls the venture capital investors placed on each company, and the outcome of those changes on performance. How did the VCs' need for information, control, management of risk, and general information flow impact the company? And how did this impact the over all financial performance of the company?

Taking a more detailed view of the balance sheet, Manigart and Baeyens look at the effect a venture capital investment has on attracting additional financial assets, both long and short term. For their study they assembled five-year data for several hundred companies, splitting the sample between venture capital and non-venture capital companies. The specific events tracked for these companies were: new external equity after original VC investment; new long term debt; new short term debt; and new bank debt. Further, they look at the

terms of the new debt and reveal who gets better terms. Which would you guess? You might just be wrong.

Richard Arend tackles the idea of company performance, in this case, during the Internet bubble. He uses a technique called "dyads" which entails matching an Internet firm with a non-Internet venture of similar industry and filing date. This technique, while difficult, can lead to powerful insights on the effect of the Internet on stock performance among similar companies taken public in similar time frames. Do you think the Internet companies did better or worse than their matched-pair non-Internet firms? The answer will probably surprise you.

And what to do if all else fails? Christopher Lisle has an interesting idea: perhaps it is time to ask an outside consultant to help you look at acquisitions. His approach is directed primarily at the merger and acquisition market, but there is meaning here for us all. How systematically do you analyze opportunities? How objective are you? How carefully do you review the metrics of market due diligence? And how about competitive analysis? Human capital? Customer needs and fulfillment? Each a critical issue, each addressed in this thoughtful presentation.

James E. Schrage, Editor
Chicago, Illinois