

GOAL INCONGRUENCIES IN THE VC-ENTREPRENEUR RELATIONSHIP: INSIGHTS FROM A CASE STUDY IN THE EUROPEAN ENERGY TECHNOLOGY SECTOR

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1. Introduction

Venture Capital is an important instrument of entrepreneurial finance. Venture capitalists contribute to the growth of entrepreneurial firms through financial (capital provision) and non-financial (management support) contributions. It has been widely acknowledged that the VC-entrepreneur relation is characterized by high information asymmetries, making it difficult to avoid opportunistic behaviour. VC research has shown how typical contractual terms of VC investments help to address these problems and minimize opportunistic behaviour. Agency theory has been widely used as a theoretical framework, usually attributing the agent role to the entrepreneur and interpreting the VC as the principal who disciplines the entrepreneur's behaviour. Based on an in-depth case study of a high-growth German energy technology venture that has received several rounds of VC financing, but has eventually failed, we take a closer look at the applicability of agency theory to interpreting the VC-entrepreneur relationship. This helps us to demonstrate how several factors influence this relationship. In particular, the higher the complexity of the deal (e.g. complexity of the technology, size of the VC syndicate, number of alliances for market entry, etc...) and the greater the deviation from the original business plan, the more pronounced are goal incongruencies between VCs and entrepreneurs likely to occur. We highlight differences of the situation before initial investment, between financing rounds and after subsequent financing rounds, and show that goal incongruencies between VCs are at least as likely to influence venture success as those between VCs and entrepreneur.

2. Methodology

The proposed paper is based on an in-depth case study of a German energy technology firm (hereafter named Alpha Inc. For reasons of confidentiality, the original company name will not be disclosed). A set of 14 interviews were conducted with founders, members of the management team, investing venture capitalists, and one non-investing VC as external expert. Secondary Table 1 shows the data sources in detail. It should be noted that one of the co-authors was closely involved in the deal while working for one of the investing VC funds. However, to ensure reliability and validity, all the primary interviews were led by one of the co-authors who had been independent of the investment process.

Table 1: Data sources

| Primary | Secondary |
|--|---|
| 3 preliminary interviews with entrepreneurs | 2 additional interviews with Alpha Inc. investors by one of the co-authors |
| 4 interviews with entrepreneurs | Confidential due diligence material prepared by one of the co-authors while he was working with one of the investing VC funds |
| 4 interviews with investors (of which 1 telephone interview) | Publicly accessible information on Alpha Inc. |
| 1 interview with a Venture Capitalist who followed the developments but did not invest in Alpha Inc. (External expert) | Academic papers |
| | Business press articles |

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3. Results

The proposed paper will answer a three-fold research question:

- When do goal incongruences occur in the VC - Start-up relationship?
- When and why do goal incongruences result in opportunistic behaviour?
- How does this correspond to the assumptions of Agency Theory?

With regard to the first part of the research question, we distinguish distributive goal incongruences, where one party reaches a goal by directly violating interests of other parties, and derived goal incongruences, which infringe others' interests as a secondary effect. We find that distributive goal incongruences occur at investment rounds and crisis situations, whilst derived goal incongruences can be identified at all stages of start-up development. Several potential goal incongruences were identified in the course of the case study analysis, providing a much richer picture than extant VC literature, such as:

- Limited financial clout could lead a (group of) VC(s) to obstruct a financially strong VC from joining, in fear of losing influence, potentially reducing start-up performance.
- Syndication leads to a reduction of risk for an individual VC, but also reduces proportional ownership of each VC, altering the cost-benefit balance of each VC, leading to potential free-rider problems regarding non-financial value added.
- External fundraising considerations might lead a VC to change the size or timing of investment rounds, potentially reducing start-up performance. Additionally, the same considerations might lead a VC to continue funding a write-off, leading less insightful VCs to join.
- Personal egos of start-up managers might lead them to refrain from resigning, though external management would be better suited for the position.

Goal incongruences lead to opportunistic behaviour when the player prioritises one goal over another and is able to sufficiently influence developments in the desired direction. All parties can utilise information asymmetries, formal and coercive power to reach their goal, save an external VC, who does not yet have any formal power. The motivation to act opportunistically is subject to a cost – benefit analysis of the player, weighing the advantages of one goal, such as higher influence, over others, such as the performance of the startup. Additionally, several factors reduce the propensity to act opportunistically: First, if the opportunistic behaviour leads to lower start-up performance, the player will have to pay part this, proportionally to the ownership share. Second, opportunistic behaviour might “backfire” due to future mutual dependencies. Third, contractual clauses are likely to reduce the benefit if not turn it into a disadvantage in the long term.

4. Discussion

In the discussion it was found that agency theory only deals with part of the opportunistic behaviour occurring in the VC – start-up relationship. Agency theory assumes that opportunistic behaviour is enabled by information asymmetries. However, in the VC – start –up relationship, leverage in the form of formal and coercive power plays a central role. The second major finding is that agency theory does not dictate who the principal is and who the agent is in a partnership with mutual ownership. Accordingly, the current simplification of the VC – start-up relationship that the VC is the principal and the start-up is the agent is questioned. The analysis clearly shows that any party is motivated and able to act opportunistically towards other parties, including among VCs. Third, the findings of extant literature (e.g. Arthurs and Busenitz 2003) are expanded. Given an assumption that the start-up is the agent, agency theory explains part of the VC – start-up relationship at investment rounds, as the start-up is motivated and able to oversell their value. Additionally, start-up managers might be motivated and able to act opportunistically in crisis situations. However, the start-up does not have much motivation to act opportunistically between investment rounds. As the VCs trust the start-up not to act against the common interests, the explanatory power of agency theory is very limited.

5. Theoretical/Empirical/Methodological Advances of Contribution

Our proposed paper advances the VC literature in several ways. Based on our case study, we add new insights to the discussion about boundaries and limitations of agency theory for investigating the VC-entrepreneur relationship. We also highlight the diverging interests among members of a venture capital syndicate, and demonstrate how these and other factors can eventually lead to failure of the entrepreneurial firm. Methodologically, our paper is innovative in that it conducts an in-depth qualitative case study of a failed venture. While the large majority of VC literature has an inherent survivorship bias by relying on ex post analyses of successful ventures, we found it a very fruitful experience to go and interview both members of the entrepreneurial team and investing venture capitalists right at the time where Alpha Inc. filed for bankruptcy. We believe that by this careful (and, admittedly, lucky) timing, our interviewees were eager to share insights that they would otherwise have kept for themselves, willing to digest their experiences and collectively embark on an attempt to understand the reasons for both the previous success (during several subsequent financing rounds) and the ultimate failure.

6. Literature

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