2 Venture Capital and Contracting

This chapter introduces the reader to venture capital and contracting, thereby laying the conceptual foundations of venture capital investing and contracting. In a brief introduction to venture capital, it presents important definitions, explains the investment process, and portrays the German venture capital market and the prevailing legal environment. It then moves on to describe venture capital contracts, their legal documents and components. Finally, the augmented contracting approach underlying the subsequent theoretical and empirical analyses is defined.

2.1 Venture Capital Fundamentals

2.1.1 Definitions

The term "venture capital" was created in the USA in the 1960s and later became accepted in the UK and subsequently on the continent. When venture capital slowly developed into a mainstream asset class, it was more and more often referred to as private equity in the USA and later across Europe.[13] As a result, the boundaries between the terms "venture capital" and "private equity" are blurred and with them market segmentation. It is therefore necessary to define how the term "venture capital" is used throughout this thesis and how it is distinguished from the term "private equity".

Venture capital and private equity refer to the financing provided to companies by institutional investors acting as financial intermediaries charged with investing the funds provided by a number of private and/or institutional investors. The capital is invested into the investee or portfolio companies in order to support a positive and profitable development, for example in the form of growth,

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[13] See Leopold et al. (2003), p. 3.

market success, reorientation, restructuring, or innovation marketing. [14] Additional support is provided by the investors in the form of intensive guidance and advice on various managerial aspects. This is referred to as "hands-on management".[15] In return, the investors hold equity stakes or equity-like claims without collateral in the companies and therefore also bear the associated entrepreneurial risks. To diversify these and other portfolio company-specific risks, they hold a portfolio of stakes in different companies. Their goal is to participate in the companies' value-added and to profitably divest their equity stakes or equity-like claims in the medium or long term, that is, after five to ten years.[16] Despite resemblances with respect to the investment process, venture capital can be distinguished from private equity by the companies' evolutionary stage at which financing is provided.[17]

Venture capital refers to investments in companies in their early (seed and start-up) and later lifecycle stages (expansion, bridge, turnaround). It does, however, include neither informal business angel investments[18] nor buy-out investments. The lifecycle stages can be defined as follows:[19]

- *Seed capital* finances the research, assessment, and development of ideas and initial concepts up to the production of a prototype.
- *Start-up capital* finances product development as well as initial marketing activities. The financed companies have only recently started their business activities, and have therefore not yet reached the break-even point.
- *Expansion capital*, also referred to as development capital, finances the growth or expansion in the form of increases in production capacities,

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14 See Leopold et al. (2003), p. 3.

15 See Frommann and Dahmann (2003), pp. 5–7.

16 See Schefczyk (2000), p. 9, and Schmidt (1985), p. 421.

17 For an overview of the definitions of the terms "venture capital" and "private equity", see Figure 2-1.

18 Business angels are wealthy private individuals, mainly experienced entrepreneurs, who invest personal assets and share their business management and industry expertise and know-how in order to advise and actively support the entrepreneur in the early days of his or her business's existence. They invest smaller amounts of capital than seed and start-up venture capitalists and are invested on average in only three to six companies. See Grabherr (2001), pp. 34, 37–38.

19 See BVK (2005b), p. 1.