

Paper no. 2006/13

## **Informal investors and value added: what do we know and where do we go?**

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<http://www.circle.lu.se/publications>

ISSN 1654-3149

**WP 2006/13**

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Informal investors have been highlighted as important stakeholders for potential highgrowth ventures. Extant empirical research provides evidence that they contribute not only with money but also bring added value in terms of providing their skills and experience to support the continued development and growth of the ventures in which they have invested. However, despite the reported benefits of the value added provided by informal investors there are very few studies that explicitly address the issue of informal investors and value added. The present paper seeks to meet this shortcoming by presenting a review of state-of-the-art literature and research on informal venture capital and value added. The objective is to summarize what we know as a basis for where research should go in the future. The literature review identifies four main core functions provided by informal investors. The identification of different core functions is then used to guide future studies of informal investors and value added. The paper ends with a concluding summary.

**Keywords:** informal investors, value added, venture capital.

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## **Informal Investors and value added: What do we know and where do we go?**

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Informal investors have been highlighted as important stakeholders for potential high-growth ventures. Extant empirical research provides evidence that they contribute not only with money but also bring added value in terms of providing their skills and experience to support the continued development and growth of the ventures in which they have invested. However, despite the reported benefits of the value added provided by informal investors there are very few studies that explicitly address the issue of informal investors and value added. The present paper seeks to meet this shortcoming by presenting a review of state-of-the-art literature and research on informal venture capital and value added. The objective is to summarize what we know as a basis for where research should go in the future. The literature review identifies four main core functions provided by informal investors. The identification of different core functions is then used to guide future studies of informal investors and value added. The paper ends with a concluding summary.

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### **Introduction**

Informal investors are individuals who offer risk capital to unlisted firms in which they have no family related connections. The scholarly attention to informal investors have increased rapidly in recent years and we can now find studies from the US (Wetzel 1981, 1983, Harr, Starr and MacMillan 1988, Aram 1989, Freear, Sohl and Wetzel 1997), Canada (Duxburry, Haines, and Riding 1996), UK (Mason, Harrison and Chaloner, 1991, Mason and Harrison 1994, Mason and Harrison 1996, Van Osnabrugge 1998; Kelly 2000, Paul, Whittam and Johnston 2003), Germany (Stedler and Peters 2003), Japan (Tashiro 1999, Kutsuna and Harada 2004), Singapore (Hindle and Lee 2002), Australia (Hindle and Wenban, 1999) and the Nordic countries (Landström, 1992; 1993; 1995; 1998; Suomi and Lumme 1994, Reitan and Sørheim 2000, Sørheim and Landström 2001). Compared with the very earliest studies in the field, the accumulated

knowledge from these studies has generated a fairly robust description of the actors in the informal venture capital market (Mason and Harrison, 2000a). In particular, the research conducted has revealed that the typical informal investor is a middle aged male that invest a relatively large amount of his personal wealth, often in young and technology-oriented firms (Mason et al. 1991, Duxburry et al. 1996, Reitan and Sørheim 2000, Hindle and Wenban 1999, Tashiro 1999, Hindle and Lee 2002, Stedler and Peters 2003). The relationship between the informal investors and the portfolio firms can moreover in most cases be characterized as fairly active, and the most common involvement is by way of active work on the board and by providing consultancy services when required (Mason et al. 1991, Landström, 1993, Mason and Harrison 1996, Frear et al. 1997, Tashiro 1999, Hindle and Lee 2002). Extant research has also pointed out that informal investors tend to work closely with their portfolio firms both as a means of promoting and protecting their interests. Even if informal investors are a very heterogeneous population (e.g., Stevenson and Coveney 1996, Sullivan and Miller 1996, Sørheim and Landström, 2001) there seem consequently to be some defensible generalities among many of them.

Informal investors play a vital role for the development and growth of new ventures both in terms of the financial capital they invest as well as in contributing with their entrepreneurial skills, expertise and personal networks acquired throughout their professional lives (Mason and Harrison 2000a). However, despite the widespread recognition that informal investors bring added value in addition to financial capital to support the continued development and growth of their portfolio firms there is almost a complete lack of studies that explicitly address exactly what kind of value added they provide to firms in the early-stages of their development. There is very limited empirical data on these issues and existing findings are scattered throughout a broad number of studies. Based on this observation, the objective of this paper is to summarize what we know about the value-added services that these investors perform, which will serve as a basis for where research should go in the future. The objective is met through a review of state-of-the-art literature and research on venture capital.

This paper contributes to literature and research on informal investors mainly in two important ways. First, it provides an overview of previous literature and research on informal investors and value added. Despite a considerable interest in the value added

activities of formal venture capital organizations (e.g., Gorman and Sahlman 1989, MacMillan, Kulow and Kholyian 1989, Sapienza 1992) the same interest has been lacking in studies of informal investors. This is a bit strange considering the utmost importance of value added for both informal investors and entrepreneurs. Second, the paper presents a categorization of various value added benefits. Up to date, empirical reports have not been very clear of what the value-added contribution of informal investors consist of, and existing empirical reports have been scattered throughout the literature. There is consequently a lack of knowledge of the value added benefits of informal investors, despite that this can be considered particularly important for understanding their contribution in new and small entrepreneurial ventures where in-house knowledge and resources can be scarce or non-existing (Quinn and Cameron 1983, Storey 1994). The paper hopefully provides a step in this direction.

The rest of the paper proceeds in four sections. Section two presents a review of literature and research on the problems facing new potential high-growth ventures in attracting long-term finance. In this section the equity capital gap is first discussed, followed by the identification of the importance of informal venture capital as a source of equity finance for new ventures with a growth potential. Section three gives an overview of research that has reported on the value added services of informal investors. Four main value adding functions are identified. In section four the discussion continues by presenting some reflections for future research on informal investors and value added. The paper ends in section five with a concluding summary.

### **The problem facing new ventures in attracting long term finance**

New ventures face considerable challenges in their early stages of their development, something which may hinder their continued expansion and growth. One of the main challenges that have been highlighted in the public debate has been the equity capital gap, referring to the problems facing new and small ventures in attracting long-term finance from new owners (Mason and Harrison 1995). The equity capital gap has been especially noticeable for potential growth ventures as they generally are in need of external resources to be able to expand and grow rapidly (Manigart and Sapienza 2000, Mason and Harrison 2000b).

New and small ventures face an equity capital gap due to several reasons. First, many young firms have high failure rates and a highly uncertain growth potential (Ang 1991, Laitinen 1992, Timmons 1999). This uncertainty means that the financial risks are often high relative to the potential returns. Second, the relative costs of each transaction are often higher in new entrepreneurial ventures compared to larger ventures (Freear and Wetzel 1990). This precludes them from financial services like long or short term debt finance (Ang 1991). Finally, the contracting costs are generally higher in these kinds of ventures, due to the problem of information asymmetry (Fiet 1995a, Van Osnabrugge 2000). Hence, there are several reasons for why projects in seed and early-stage are highly unattractive for potential investors. As a consequence do many ventures with a growth potential face the risk of undercapitalization, in which their capital structure becomes heavily dependent upon short-term funds (Mason and Harrison 1995). The importance of a vital venture capital market can therefore be assumed to be of great importance for supporting the development and growth of entrepreneurial ventures (Timmons and Bygrave 1986).

The lack of seed and early stage financing signifies the importance of smaller amounts of true risk capital for potential growth ventures. Research however indicates that the major part of venture capital investments is made in ventures that are in the later stages of development. Venture capital firms appear to be more interested in later-stage projects where the capital is used to replace ownership<sup>1</sup> rather than being used to create further value added to the company (Mason and Harrison 1995, Mason and Harrison 1999). In light of these findings there has been a growing realization among researchers and policy makers alike that informal investors are well positioned to play a vital role in bridging the equity capital gap that new ventures face. Studies have indicated that informal investors tend to be more willing to invest smaller amounts of capital in the very earlier stages of new ventures' development (Erlach, De Noble, Moore and Weaver 1994, Freear et al. 1997, Van Osnabrugge 1998, Mason and Harrison 2000b). There are several reasons for this. First, informal investors seem to be only partly motivated by financial rewards (Mason and Harrison 1994, Van Osnabrugge 1998), which means that they are willing to make more risky investments (Freear and Wetzel 1990). Second, they use their own money and their own due diligence to invest in entrepreneurial opportunities. This means that their administration costs are small and that they can

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<sup>1</sup> As in a management buy-out or a management buy-in.

minimize the transactions costs for their investments (Landström 1993). Finally, most informal investors tend to invest in ventures that operate in industries where they have previous experience (Landström 1993, Mason and Harrison 1994, Feeney, Haines and Riding, 1999).

Informal investors are considered to be an important source of equity capital for businesses in the seed, start-up or early expansion phases of development and growth because of the large pool of potential risk capital they represent (Mason and Harrison 2000a). Early literature on informal investors tried to find out the size of the market, the characteristics of the investors, their motivation and investment criteria, and the characteristics of their investments (e.g., Wetzel 1981, 1983, Gaston 1989, Short and Riding 1989, Mason and Harrison 1996). These 'first generation studies' was highly case-dependent and descriptive. During the 1990s, the literature expanded to 'second generation studies', which focused more on policy issues and research introducing theoretical perspectives, such as the investment decision-making process, post investment relationship, and private equity finance spectrum - reflecting a growing sophistication in the analysis of the informal venture capital market (Mason and Harrison 2000a). The next section will present a review of state-of-the-art literature on informal investors with a focus on the main value-added services that these investors perform.

### **The value added contributions of informal investors: what do we know?**

Informal investors are generally considered to be value added investors that support the development of new ventures in addition to the supply of financial capital. This acknowledgement stems from that most informal investors have an enterprise background which often includes entrepreneurial and management experience (Aernoudt 1999). Several studies have for example pointed out that informal investors have a genuine entrepreneurial career background, in which they often have made their fortunes through a cash-in of their own previous ventures. In a study of informal investors in the US, Wetzel (1981) reported that 78% had previous start-up experience. In a later US study, Gaston (1989) reported that more than 83% of the surveyed investors had previous start-up experience. This pattern is similar also outside the US. In a study of informal investors in Canada, Short and Riding (1989) reported 84%. In a UK study by Mason et al., (1991) they found that 67% of the surveyed informal investors had previous start-up experience. Tashiro (1999) examined informal investors in Japan and

found that about 60% had experience from founding their own business. In a recent study of informal investors in Singapore, Hindle and Lee (2002) found that 72% has experience from managing their own businesses. The most impressive results in terms of prior entrepreneurial experience however come from the Nordic countries. In a Swedish study Landström (1993) report that as many as 96% of the informal investors had previous start-up experience, while Suomi and Lumme (1994) in a study from Finland report 95%. In a recent study of Norwegian informal investors Reitan and Sørheim (2000) report that even if 46% had prior start-up experience, most of the surveyed informal investors had management experience from new ventures or in relation to company ownership. It consequently seems that a consistent pattern is that the larger majority of informal investors seem to have acquired the kind of experience it takes to start, manage and harvest a successful entrepreneurial venture (Van Osnabrugge 1998, Aernoudt 1999, Wright, Westhead and Sohl 1998).

Judging from the prior studies reviewed above, it seems reasonable to assume that the informal investors' prior enterprise background have prepared them to conduct the due diligence necessary to evaluate the merits and risks of prospective investments, and to add value based on their extensive experience and business know-how in the ventures in which they invest. In particular they are expected to contribute with a wide range of services, such as commercial skills, entrepreneurial experience, business know-how and contacts. This contribution is facilitated through a variety of hands-on roles ranging from board membership to less structured consulting activities and formalized part-time employments (Landström 1993, Mason and Harrison 1996).

However, exactly what this value-added consist of is not very clear, and empirical reports on the issue are scattered across various countries and contexts (e.g., Ehrlich et al. 1994, Freear, Sohl and Wetzel 1995, Mason and Harrison 1996, Stevenson and Coveney 1996, Tashiro 1999, Paul et al. 2003). In a UK study of 36 informal venture capital-backed new ventures, Harrison and Mason (1992) identify a wide range of support played by informal investors in their investee companies. Acting as sounding board was their most valuable hands-on contribution and the entrepreneurs found their involvement in new business strategy as most rewarding. Similar results were reported by Ehrlich et al. (1994) in a study of 47 US entrepreneurs which have received venture capital from informal investors. They found that the most important areas of value added



from informal investors were interfacing with the investor group, monitoring financial performance, serving as a sounding board and formulating business strategy. In another US study, Freear et al. (1995) report the findings from a study of 124 firms that have raised one or more rounds of capital from informal investors. In the study they emphasize more 'intangible' contributions from informal investors as they report that they add value mainly through establishing a productive working relationship with the management team in the venture they finance. Reporting from a survey of 31 informal investors and 28 owner-managers in the UK, Mason and Harrison (1996) found that the main contribution of informal investors was the provision of strategic advice. Other important contributions in the study included networking (especially with customers), finance and accounting, and general management. The surveyed investors believed their single most important contribution was their general business experience. There was however no consensus of the most important contribution perceived by the entrepreneur. Specific contributions that were mentioned included such diverse areas like accounting, project planning, marketing, and financial control. In addition, there were some more 'intangible' contributions reported such as "lifting the spirits", "sharing the burden" and "providing a broader view" (Mason and Harrison 1996:117). In another study, Stevenson and Coveney (1996) report the findings from a study of 484 informal investors in the UK. They find that investors perceive advice and hands-on involvement to be their main value added contribution. Tashiro (1999) in his study of Japanese informal investors noted that they often provided business advice to the businesses in which they invested in. This support was usually in the area of management, but some of them also provided more specific advice regarding technology, human resources or finance. Moreover, in a recent study Paul et al. (2003) surveyed informal investors in Scotland. They found that the main non-financial value added benefits were provision of business contacts, enhancing the management skills in the new venture, and helping with raising additional funds. The empirical reports are summarized in table 1 below.

**Table 1. Prior studies of informal investors and value added**

<b>Study</b>	<b>Country</b>	<b>Main value added benefits</b>
Harrison and Mason (1992)	UK	<ul style="list-style-type: none"> <li>• Serving as a sounding board</li> <li>• Strategic advice</li> </ul>
Ehrlich et al. (1994)	US	<ul style="list-style-type: none"> <li>• Interfacing with investor group</li> <li>• Monitoring financial performance</li> <li>• Serving as a sounding board</li> <li>• Formulating business strategy</li> </ul>
Freear et al. (1995)	US	<ul style="list-style-type: none"> <li>• Establishing working relationship with entrepreneur</li> </ul>
Mason and Harrison (1996)	UK	<ul style="list-style-type: none"> <li>• Strategic advice</li> <li>• Networking activities,</li> <li>• Advice and counsel (in marketing, finance and accounting, and general management)</li> <li>• 'Lifting the spirits', 'sharing the burden' and 'providing a broader view'</li> </ul>
Stevenson and Coveney (1996)	UK	<ul style="list-style-type: none"> <li>• Serving as sounding board</li> <li>• Hands-on involvement</li> </ul>
Tashiro (1999)	Japan	<ul style="list-style-type: none"> <li>• Business advice (general management, but also human resources, technology and finance)</li> </ul>
Paul, Whittam and Johnson (2003)	UK (Scotland)	<ul style="list-style-type: none"> <li>• Business contacts</li> <li>• Enhancing management skills</li> <li>• Raising additional funds</li> </ul>

As can be seen in table 1 the empirical reports show a wide range of different value added benefits from informal investors. It is without doubt that these studies have merit in showing the important value added potential of informal investors. However, despite good intentions we fear that without the accumulation of knowledge around a concentrated set of value adding core functions continued research on these issues may risk leading to a growing fragmentation rather than to a growing consensus in the understanding of informal investors and value added. In our view, focusing on similarities rather than on pluralism and differences may be a viable future research path. To follow this suggestion we will identify some value adding core functions that are commonly referred to in the literature that potentially may serve as underlying concepts for a better understanding of informal investors and value added.

### *The networking function*

A core function that can be identified in the literature is the 'networking function'. This function can be related to value added benefits such as interfacing with investor group, networking activities, providing business contacts and raising additional funds. One of the main obstacles facing small firms in their early phases of development is their lack of stable links to important key stakeholders in their surroundings (Stinchcombe 1965, Aldrich and Zimmer 1986). The networking activities of informal investors can here be seen as helpful supporting the early development and growth of the new venture, for example in extending individual ambitions into collective efforts. The venture capital literature moreover suggests that the social network provided by informal investors is a key source of value creation and competitive advantage in which they develop, manage and recombine sets of network relationships to key stakeholders (Wetzel 1983, Mason and Harrison 1994, Fiet 1995b, Steier and Greenwood 2000, Sørheim 2003). Main activities include making introductions to potential suppliers and customers, and facilitating the process of raising additional capital. The capacity for learning and retention from the external environment by means of networking is moreover often assumed to influence networking as a means of utilizing prior connections to enhance the survival chances of their new businesses (Aldrich and Zimmer 1986, Johannisson 2000). The presence of network relationships can for example facilitate the exploitation of further entrepreneurial opportunities (Johannisson 2000, Minguzzi and Passaro 2000). The ability to develop, manage and recombine the network relationships provided by informal investors may hence be a critical issue for maximizing firm specific advantages in new ventures.

Taken together, the 'networking function' is based on the ability of the informal investor to establish a social network of supportive relationships that facilitates the access to information, resources and further entrepreneurial opportunities (Wetzel 1983, Mason and Harrison 1994, Fiet 1995b, Sørheim 2003). The trust carried by social networks may in this respect bring legitimacy as well as helping to mediate human, as well as financial, capital (Steier and Greenwood 2000, Sørheim 2003). This makes the venture better prepared for acting on unexpected opportunities that arise in the marketplace as they have the necessary information and knowledge about when to act in order to take advantage of the 'strategic windows' that appear (Harvey and Evans 1995). This indicates that the competitiveness of the new venture that the informal investor can

contribute with can be regarded much as a network-embedded capability (Minguzzi and Passaro 2001, Sørheim 2003).

#### *The mentoring/coach function*

Another core function that can be identified in the literature is the 'mentoring/coaching function'. This function can be related to value added benefits such as serving as a sounding board and establishing a working relationship with the entrepreneur. Being less tangible than the networking function in the sense that this value added benefit is harder to grasp, the mentoring/coach function is by any means important for developing a trusting relationship between the investor and the entrepreneur (Wetzel 1994, Harrison and Dibbon 1997). It has been suggested that there is greater need for knowledge exchange under conditions of complexity and rapid change of technology and markets, and that these conditions favour the instruments of mutual advantage and trust (Noteboom 2000). This seems to be particularly evident in the context of informal venture capital investments where trust relationships between the investor and the entrepreneur are a crucial ingredient for that the outcome of the partnership will be successful (Perry 1988, Cable and Shane 1997). Excessive monitoring activities as well as short-term game playing are in this respect counter-productive as it can reduce the level of trust between venture capitalists and the entrepreneur (Landström 1992).

Research findings suggest that venture capital investors play a critical role in the development and growth of new and small ventures by creating and maintaining an open organizational climate where learning can become routinised through agent interaction and shared beliefs over time (Deakins and Freel 1998, Deakins, O'Neill and Mileham 2000, Minguzzi and Passaro 2001). A trusting working relationship can also promote added value by facilitating an organizational climate with more open reporting of firm data and more frequent reporting of concerns, which in turn can provide a more constructive alternative to traditional hierarchical control (Child and Rodriguez 2003). Previous studies have actually found that informal investors are more concerned with the evaluation of potential agency factors *before* they make an investment, as they view the intentions of the entrepreneur as being the most potentially damaging contingency that can ruin an entrepreneurial venture, (Landström 1992, Fiet 1995a). The informal investors seem in this respect to rely on friends and business associates in their social networks to provide them with information (Fiet 1995b, Sørheim 2003). This suggests

that their social networks can be used as an efficient means of information evaluation which may encourage a more reliable circulation of information between members (Chaserant 2003). This may in turn lead to a relationship that is characterized by a shared vision, mutual understanding and trust in the investor-entrepreneur relationship.

Taken together, the 'mentoring/coach function' points towards the importance of non-contractual coordination mechanisms between contracting parties in a relationship (Noteboom 2000, Chaserant 2003). This is something which can lead to alternatives to traditional hierarchical control like reputation and social networks (Child and Rodriguez 2003). It has even been suggested that trust should be an integral building block in all contractual relations in order to stimulate learning, innovation and organizational development (Noteboom 2000, Shapira 2000). Trust can in this respect lead to improved performance as it economizes on transactions costs, as well as it generates superior commitment and promote collective learning (Child and Rodriguez 2003). It consequently seems reasonable to assume that informal venture capital investments can imply reduced agency costs in the post-investment relationship as the investors can rely on mutual understanding and trust in order to minimize the risk of opportunism and self-interested behaviour.

#### *The strategic function*

A third core function that can be identified in the literature is the 'strategic function'. This function can be related to concrete value added benefits such as providing strategic advice and counsel, monitoring financial performance, formulating business strategy, and enhancing the management skills in the venture. New and small firms have often limitations in their strategic resources (Storey 1994) and in-house competence may either be scarce, or non-existing among the members of management (Shepherd, Douglas and Shanley 2000). To overcome this lack of resources, it may be important to rely on the assistance of outside expertise to aid the growth and development of new and small firms (Deakins et al. 2000). Informal investors may consequently enhance a firm's initial resource base by contributing with their managerial competence they have built up during their professional lives (e.g. Mason et al. 1991, Landström 1993, Duxburry et al. 1996, Aernoudt 1999, Politis and Landström 2002).

Furthermore, it seems reasonable to assume that informal investors add value by using their management know-how to reconcile organizational capabilities and external expertise in order to maximize firm specific advantages and achieve sustainable competitive advantage. From previous studies it seems that informal investors are likely to contribute in a number of strategic areas, such as acting as a sounding board for management and advising as to the manner and timing for realizing the value being created within the firm (Ehrlich et al. 1994, Mason and Harrison 1996). The prior business experience seems to provide an important basis for adding value in the ventures in which they invest due to their gained business expertise and management know-how (Wetzel 1994, Mason and Harrison 1996, Politis and Landström 2002). The informal investors seem to possess unique capabilities developed throughout their careers, which in turn gives them opportunities to combine a wide set of diverse competencies to recoup ideas and creativity for the realization of entrepreneurial start-ups (Van Osnabrugge 1998, Wright et al. 1998, Politis and Landström 2002).

Taken together, the 'strategic function' is based on the informal investors' management experience and business know-how (Harrison and Mason 1992, Ehrlich et al. 1994, Mason and Harrison 1996). Informal investors seem in this respect to utilise the competence base gained from previous projects they have been involved in during their careers to enhance the survival chance of the businesses in which they later invest (Politis and Landström 2002). As such, it is possible to assume that informal investors invest in industries where they have previous experience, which in turn may give the firms a competitive advantage over firms without investor involvement. This ability to pursue additional resources and design appropriate mechanisms of exploitation seems consequently to facilitate the extension of their personal know-how into organizational know-how, something that can result in the development of unique advantages in new ventures (Brush, Green and Hart 2001).

#### *The entrepreneurial function*

A fourth core function that can be identified in the literature is the 'entrepreneurial function'. This function can be related to the provision of less tangible benefits like 'lifting the spirits', 'sharing the burden' and 'providing a broader view' as well as providing hands-on involvement based on their extensive experience of working in (or in relation to) entrepreneurial ventures. This core function has to do with the infusion of an

entrepreneurial drive and implementing entrepreneurial values in the organization (Mason and Harrison 1996) and seems to come from informal investors' perception of themselves as entrepreneurs rather than as financiers. Several studies have for example revealed that they often have the same personal characteristics and motives (e.g. need for achievement, locus of control, independence, intrinsic motivation etc.) as entrepreneurs in general (Sullivan 1991, Duxburry et al. 1996), and that they often have a genuine background as entrepreneurs (Sullivan 1991, Landström 1993, Duxburry et al. 1996, Van Osnabrugge 1998, Aernoudt 1999). A prime motive for their investments is the opportunity to create businesses and to play an active part in the entrepreneurial process (Mason and Harrison 1994, Landström 1998). Previous studies have even shown that informal investors generally still consider themselves as entrepreneurs rather than ex-entrepreneurs in their subsequent careers as informal investors (Sullivan 1991, Aernoudt 1999). Based on these findings, it seems appropriate to regard informal investors as 'co-entrepreneurs' rather than purely financiers of entrepreneurial ventures (Lindsay 2004). This line of reasoning can be related to the ways informal investors consider their financial investments. Several studies have pointed out that informal investors are likely to regard their financial investment as an extension of their own entrepreneurship, rather than as a purely financial placement (Mason and Harrison 1994, Landström 1998, Van Osnabrugge 1998, Aernoudt 1999). This point of view is further supported by findings suggesting that informal investors regard their investments mainly as 'subjects' (Landström 1998), in which a prime motive for making informal investments is the opportunity to create businesses and to play an active part in the entrepreneurial process (Mason and Harrison 1994, Landström 1998). This can be compared with the institutional venture capitalists who often regard their investments as an 'object' - a financial investment in which they primarily focus on issues such as financially 'packaging' the firms they are entering, complementing the resources, and solving problems that arise in the firm (Landström 2000). It seems possible to assume that informal investors consider their investment as a 'business idea', whereby they make use of their earlier experiences as entrepreneurs, and hence can take an active part in the entrepreneurial process in new ventures (Mason and Harrison 1996, Landström 1998).

Taken together, the 'entrepreneurial function' is based on the informal investors' preference for playing an active part in the entrepreneurial process by their hands-on

involvement (Mason and Harrison 1996). Informal investors seem in this respect to search for challenging investments in order to make use of their previous experiences, as well as facilitating continued learning and development by taking part in the entrepreneurial process. Politis and Landström (2002) even pointed out that informal investors not only exploit their pre-existent knowledge through their post investment activities, but also continues to create opportunities to learn and develop new competencies. This suggests that the informal investment activity can be seen as one of several expressions of their entrepreneurial propensity, representing an additional way for informal investors to expand their own business activities (Landström 1998, Lindsay 2004).

*Summary: a sorting logic of informal investors and value added*

Based on the discussion above, it seems reasonable to conclude that informal investors provide several value added benefits to new ventures with a growth potential. A review of literature and research on informal venture capital shows that the value added benefits can be divided into four different main core functions provided by informal investors. It moreover seems possible to differentiate the four different core functions along two major dimensions. First, they seem to differ in their emphasis on value added benefits based on either their social capital or human capital. Social capital refers to features of the informal investors' relationship networks that mediate norms and social trust and facilitate coordination and cooperation for mutual benefit (Sörheim 2003). The value added benefits based on social capital is 'the provision of links to key stakeholders' and the 'development of a trusting working relationship with the entrepreneur'. Human capital refers on the other hand to the set of knowledge and skills which the informal investors have acquired through their jobs, training and experience (Ucbasaran, Wright and Westhead 2003). The value added benefits based on human capital is 'the provision of business know how and management expertise' and 'infusing entrepreneurial values in the new venture'. In sum, both social and human capital can be seen as personal assets and qualifications that informal investors have developed throughout their professional careers (Politis and Landström 2002).

The second dimension is based on that the four identified value added core functions seem to differ in their focus on benefits that can be characterized as more or less tangible. Tangible should here be interpreted as to what extent the value added benefit



is palpable or concrete in the sense that it can be appraised at an actual or approximate value. The more tangible benefits among our four value added core functions is ‘the provision of links to key stakeholders’ and ‘the provision of business know how and management expertise’. These benefits can more easily be perceived, measured and evaluated objectively, for example the number of contacts added to the ventures network or the amount of time spent in giving business advice. The less tangible benefits among our four value added core functions is ‘the development of a trusting working relationship with the entrepreneur’ and ‘infusing entrepreneurial values in the new venture’. These benefits are more abstract, subjective and imaginary and much harder to being perceived by the senses. The sorting logic is summarized in figure 1 below.

**Figure 1: Informal investors and value added: a sorting logic**

	<b>Value added based on social capital</b>	<b>Value added based on human capital</b>
More tangible benefits	<i>Networking function</i> -providing links to key stakeholders	<i>Strategic function</i> - providing business know how and management expertise
Less tangible benefits	<i>Mentoring/coach function</i> – developing trusting working relationship	<i>Entrepreneurial function</i> – infusing entrepreneurial values

#### **Informal investors and value added: where do we go?**

This section will provide a basis for where research on informal investors and value added may head in the future. The identification of different core functions in figure 1 may provide a basis for future studies of informal investors and value added. First, the different core functions can be used as a guiding principle for developing a more detailed specification of various value added services provided by informal investors under each category. The networking function may for example include various sub-activities, such as resource acquisition, lobbying and information search, etc. The same applies for the other identified core functions. There is also a need to better understand the theoretical

underpinning of the different value creating core functions. It seems for example that the networking function can be related to the resource dependency perspective (Pfeffer and Salancik 1978) or social network theories (Granovetter 1985, Gulati and Gargiulo 1999). The mentoring/coach function may on the other hand find more proper theoretical grounding in concepts from stewardship theory (Davis, Schoorman and Donaldson 1997) or theories of social exchange (Sapienza and Korsgaard 1996, Whitener, Brodt, Korsgaard and Werner 1998). For developing insights into the strategic function the resource based view as applied in new and small firms (Brush et al. 2001, Lichtenstein and Brush 2001) can probably serve as an appropriate point of departure. Inquires into the entrepreneurial function may instead draw from theories of learning applied in entrepreneurial contexts, where skills, values and attitudes often are brought together in order to exploit business opportunities that arise (Gibb 1997, Deakins and Freel 1998, Busenitz, Fiet and Moesel 2004). Studies of informal investors and value added have however up to date primarily been conducted with postal questionnaires, with rather limited detail and with very limited theoretical grounding. While large-scale postal questionnaires can be considered appropriate when the focus is on gaining overview knowledge of the characteristics of the market and its actors, it is less suited for developing theory of the value added activities informal investors perform in the post investment phase. Future studies of informal investors and value added should therefore consider making use of more theory-building case studies (Eisenhardt 1989, Yin 2003) to further explore the value added benefits of informal investors, before large-scale empirical investigations can be made.

Second, a qualifying question could also be to examine how the value added core functions performed by informal investors may vary between different kinds of informal investors. Research suggests that informal investors are a heterogeneous group of individuals and that there are significant differences among them in terms of experience and competence (Stevenson and Coveney 1996, Sullivan and Miller 1996). A study that may serve as a complementary base for further research in this direction is the one conducted by Sørheim and Landström (2001). In their study of Norwegian informal investors they used cluster analysis to identify different categories based on their 'competence' and 'investment' activity. The 'competence' dimension was measured in terms of prior management and entrepreneurial experience, while the 'investment activity' dimension was measured in terms of investment size and type of involvement

that was usually performed. This created a 2x2 matrix with four categories of informal investors. The four categories of informal investors were labeled: i) 'lotto investors' - individuals with low competence and low investment activity, ii) 'traders' - individuals with low competence but high investment activity, iii) 'competent investors' - individuals with high competence but low investment activity, and iv) 'business angels' - individuals with high competence and high investment activity. According to the categorization, 'business angels' and 'competent investors' have the highest degree of management and entrepreneurial experience, while 'business angels' and 'traders' are the ones that are most active in the portfolio firms in terms of being board members and/or involved as consultants. These differences should also be reflected in the potential value added that they provide. It is for example reasonable to assume that 'business angels' with their high level of competence in terms of prior entrepreneurial and management experience and high investment activity are likely to have the greatest ability to give value added beyond the money supplied (see also Wright et al. 1998 for similar reasoning). However, it is not clear whether these different categories of investors contribute differently in terms of different value adding core functions. A viable path for future research is consequently to explore this issue.

Third, the identification of different core functions highlights the question of how the informal investors' emphasis on various core functions will change during the development of the venture. It is for example likely that there is a 'honey moon' period in the beginning of the relationship, characterized by high commitment and individual effort by the informal investor. This period may then turn into a period where the informal investor reduces his or her involvement and takes a less active hands-on role when the first emotional excitement drops. How these changes affect the value added functions provided by the informal investor is however yet unclear. At best, future research on this issue will be facilitated by samples of informal investors who have made investments at different time periods. This would allow for the isolation of their immediate post investment attitudes and activities from their long term post investment strategies.

Fourth, the different core functions can also be used as a basis for comparing their relative impact on the performance of the new venture. It may for example very well be the case that some value adding core functions are more crucial than others in order to fuel continued growth during different phases of a new venture's development (Churchill

and Lewis 1983). This may call for a contingency approach (Donaldson 2001). A contingency approach would emphasize that the relative importance of the different value added functions provided by informal investors may be contingent upon conditions in the internal or external environment of the venture, such as the life cycle stage of the business, the previous track-record of the lead entrepreneur, the sector where the firm operates, characteristics of the product/service etc. How the different value added core functions may influence the performance of the new venture depending on conditions in the internal or external environment of the venture is however an issue that is largely unexplored despite its relevance for both theory and practice.

Fifth, inspired by the work of Zahra and George (2002), there may also be a need to distinguish between *potential* value added and *realized* value added. The underlying argument for the need of this distinction is that just because an informal investor has the potential to contribute with added value it does not mean that this value can be effectively implemented and used in the new venture. The potential value added will here refer to the set of potential benefits that a new venture can receive from an informal investor. The realized value added will on the other hand refer to the successful implementation and incorporation of value into the venture's operations, thereby improving its performance. Previous studies have almost completely neglected this difference although this line of reasoning may have important implications for the way we should understand the value added contribution of informal investors. Instead of treating value added as a simple transferring process, the distinction suggests that people and organizations can vary significantly in their ability to effectively implement and utilize potential value added benefits that informal investors can provide. Making a distinction between potential and realized value added in future research can thus allow researchers to study why some attempts to contribute to value added fail while others thrive under the same conditions. This in turn may enhance the understanding of the process in which the potential value added contributions of informal investors can become effectively implemented and incorporated in the ventures in which they invest.

### **Concluding summary**

Informal investors represent a large reservoir of potentially relevant experience and valuable expertise for new ventures seeking external risk capital (Mason and Harrison 2000a). However, despite the reported benefits of the value added activities of informal

investors there are few studies that have explicitly addressed this issue. The objective of this paper has been to summarize what is known regarding the main value-added services that informal investors perform as a basis for where research should go in the future. This objective was met through a review of state-of-the-art literature and research on venture capital. The review of literature and research on informal venture capital identified four different value adding core functions provided by informal investors: i) the networking function, ii) the mentor/coaching function, iii) the strategy function, and iv) the entrepreneurial function. Several avenues for future research were identified based on these four different value adding core functions.

So far, relatively little is known of informal investors and value added. Nonetheless, it seems to be one of the most important issues to understand in the post-investment phase. This calls for further and intensified theory development in the area. The arguments underlying the four different core functions can be considered as an open invitation for additional research and debate on the issue, and it is our hope that the results will add new perspectives to the existing research agenda on informal investors' involvement in the post-investment phase. Future research to develop this important field of inquiry is consequently warranted.

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