



## Trust and controllability in venture capital fundraising



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### ABSTRACT

This study discusses a model of success in venture capital (VC) fundraising. We develop this model based on agency and trust theory. The model is tested against quantitative data collected from 151 limited partners (LP) with headquarters predominantly in North America and Europe. Beyond the well-known criterion of the VC firm's track record, results suggest that trust and perceived controllability shape the investment decisions of those LPs. Moreover, antecedents of these main factors are evaluated. In sum, this study shows how fundraising VC firms can systematically manage the fundraising process.

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### 1. Introduction

Venture capital (VC) firms are of vital importance especially to high-tech entrepreneurs as they provide equity for the “launch, early development, or expansion of a business” (EVCA, 2011). However, in contrast to business angels (Freear, Sohl, & Wetzel, 1994; Sullivan, 1996), they do not invest their own money but rather convey funds from their own investors to promising entrepreneurs. Thus, the first essential step in the overall VC process is framed by the necessity to raise funds from potential limited partners (LPs) such as pension funds, funds of funds, or investment banks.

Practice-oriented authors (e.g., Simpson, 2000) have developed some suggestions on how to adequately structure the process of VC fundraising, and academic research has contributed some insights into the factors that affect the success of these endeavors. For instance, some authors (e.g., Cumming, 2007; Cumming & MacIntosh, 2006) explore the role of governmental support for VC, while others (e.g., Balboa & Marti, 2007; Barnes & Menzies, 2005; Gompers & Lerner, 1998; Kaplan & Schoar, 2005) conclude that VC fundraising is predominantly determined by the individual VC firm's track record. However, as most prior research relies on the analysis of secondary data (which quite often cannot account for many potentially competing explanations), the reduction to one dominant organizational

factor, that is, the track record, leads to the conclusion that a more developed picture of VC fundraising and its antecedents for success would be desirable.

It is this apparent research gap that the present study addresses by introducing a number of behavioral variables into the equation. To answer the research question of what factors drive success in VC fundraising, we developed a model of VC fundraising and tested this model with data collected from the global population of LPs with an interest in VC funds. The structural model analyzed data compiled from responses from 151 LPs from the United States, Europe and other countries from the western hemisphere and suggests that three factors in particular drive the success of a VC firm's fundraising activities.

These are the firm's track record, the level of perceived trust, and the level of perceived controllability. Moreover, several antecedent factors of these three concepts, i.e. the length of collaboration between VC firm and LP, similarity between both parties, the degree of openness of the VC firm during the due diligence and the offered terms and conditions, can help the VC firm to better structure its fundraising tactics.

To support its model, the paper is structured as follows. The first step proposes a model of successful VC fundraising based on established concepts from agency and trust theory. Here we discuss track record, trust, and controllability as factors affecting the final decision to invest in a particular VC firm's fund, the relationship of track record and trust, and the remaining antecedents of trust and controllability. In a second step, we discuss data collection and analyze the model with an appropriate method of structural equation modeling. Finally, we discuss our findings with respect to their relevance for VC finance, both theoretically and practically.

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## 2. Developing a model of fundraising success

### 2.1. Track record, trust and perceived controllability as antecedents of fundraising success

The situation of an LP considering a particular VC fund (or, on the contrary, a VC firm trying to convince an LP to commit funds) is essentially that of a principal facing an agent (Eisenhardt, 1989). Agency theory provides an appropriate theoretical framework in every situation where a principal delegates authority and decision-making power to an agent, who performs on behalf of the principal (Jensen & Meckling, 1976; Lutz, Bender, Achleitner, & Kaserer, 2013). Here, the LP as principal is confronted with agency issues such as information asymmetries, potentially conflicting goals, and possible self-seeking behavior of the VC firm as agent. Consequently, the VC firm needs to address those issues proactively to help the principal overcome barriers and clear the way for a positive decision. Suggested general solutions from agency theory (Eisenhardt, 1989) involve the signaling of reputation, appropriate design of contracts, and trust in general.

Reputation can be signaled by the VC firm through communicating its track record, contracting is aimed at increasing the LP's perception of controllability of the investment and trust plays a significant role with respect to the final investment decision as well. Consequently, we suggest a two-step-model of VC fundraising where the agent's behavior and characteristics lead to a particular perception of the agent by the principal, which in turn affects the final decision whether capital is committed to a VC fund or not. In the following paragraphs we will argue for this model in greater detail.

The first antecedent of fundraising success is the VC firm's track record. Theoretically, the importance of the track record can be deduced from the apparent information asymmetry; the fact, that the VC firm is the better informed party and might withhold crucial information may lead to adverse selection (Amit, Brander, & Zott, 1998) which the LP is looking to avoid. As LPs need to select VC firms that are able to produce at least industry-typical returns, but are uncertain of whether a particular firm is really able to meet this goal, they rely significantly on past performance. Findings from the empirical academic literature support this view. Some authors (e.g., Balboa & Marti, 2007) suggest that VC firms can reduce information asymmetries by signaling their track record to potential LPs. In this regard, Gompers and Lerner (1998) propose internal rates of return achieved formerly as a suitable measure of track record. In order to propose a model as complete as possible, we therefore include the well established relationship of track record and fundraising success. We thus hypothesize:

**Hypothesis 1.** The better the VC firm's track record, the higher the probability of a positive investment decision by the LP.

Despite the apparent dominance of the VC's track record, other factors are important too. Decades ago, Arrow (1972) noted that "virtually every commercial transaction has within itself an element of trust" (p. 357). Trust has consequently been analyzed in a variety of disciplines such as social psychology, sociology, economics, marketing and entrepreneurship. To capture the multidimensional and complex nature of trust a plethora of theoretical approaches has been applied. What characterizes all different theoretical lenses, however, is that the trusting party must become to some extent vulnerable through trusting and the outcomes of the decision to trust must be uncertain and simultaneously of substantial importance to the trustor (Moorman, Zaltman, & Deshpande, 1992). Put another way, trust becomes particularly important in situations characterized by risk and uncertainty (Gulati & Sytch, 2008). This applies well to the situation of an LP considering a VC fund, as the long-term commitment to a particular fund makes the LP dependent on the decisions of the trustee, that is, the VC firm.

In general, people can develop trust in public institutions, organizations or individuals. In the business context, researchers usually

differentiate between trust on an interorganizational and an interpersonal level (Zaheer, McEvily, & Perrone, 1998). While the former refers to trust that emerges in the relationship between two legal entities, the latter refers to relationships between individuals. For the VC industry as a people's business in particular interpersonal conceptualizations of trust seem to be appropriate. Only a few professionals are responsible for one fund over its lifetime (Sahlman, 1990) and during the fundraising process it seems to be important that the key people relate to each other on a personal level.

We therefore adopt the trust conceptualization suggested by Doney and Cannon (1997), who define trust as the perceived credibility and the benevolence of a trustee. Various scholars have provided evidence that if such trust is established and exceeds a particular threshold (Dibben, 2000), principals tend to authorize agents. In the context of general financial decisions, Guiso, Sapienza, and Zingales (2008) substantiate a positive relationship between trust and the willingness to invest. For VC firms and their potential portfolio companies, Bottazzi, Da Rin, and Hellmann (2010) were able to provide evidence that trust has a positive effect on willingness to invest as well (for the relationship of trust and track record see Section 2.2). Especially for first-time VC funds or funds with a poor track record trust might not only be a complement but even a substitute for track record. Against that backdrop, we conclude that these causal effects can be transferred to the relationship of LPs and VC firms. We thus hypothesize:

**Hypothesis 2.** The higher the LP's level of trust, the higher the probability of a positive investment decision by the LP.

Still, in a business context it would be naive to assume that the decision about a particular VC fund would be completely based on a signal that might not continue to hold in the future (that is, track record) and a comparatively vague concept such as trust (Patel, Zeckhauser, & Hendricks, 1991). In line with Das and Teng (1998) we consider control to be a complementary concept that could be useful to close the apparent gap. Although some authors caution against this view as excessive control might inhibit the emergence of trust (Schoorman, Mayer, & Davis, 2007), the fact that LPs conduct rigorous due diligence prior to an investment and insist on a plethora of covenants, supports the view that control is an important factor in the given situation.

As LPs may face the problem of hidden action resulting in moral hazard once they have invested in the fund, express contracts in the form of partnership agreements are set up before investing in the funds to protect LPs against agency issues (Gompers & Lerner, 1996). Partnership agreements include terms and conditions that set the rules for the VC firm's compensation as well as covenants concerning the overall fund management, the activities of the general partners and restrictions with respect to certain types of investments.

However, as on the one hand those covenants are market standard and on the other hand perfect contracts are nearly impossible to negotiate, LPs as principals will search for additional forms of protection (incomplete contract approach (Hart, 1995)). Controllability beyond the scope of standard covenants is thus a key signal in the fundraising process and can be achieved, for instance, through the establishment of advisory boards or investor committees where LPs are granted a seat (Harris, 2010). Consequently, the perception of the power to enforce control (controllability) is crucial to the LP's decision to invest and a key argument in the fundraising process. We thus hypothesize:

**Hypothesis 3.** The higher the perceived controllability, the higher the probability of a positive investment decision by the LP.

Taken together, the first set of hypotheses proposes three antecedents of fundraising success. While it is quite evident that VC firms can achieve a convincing track record through successful prior investments, it is not as obvious how they can portray trust and controllability to LPs. This is the issue addressed in the following paragraphs.

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