The Social Process of Venture Capital: The Case of Western Australia

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The Social Process of Venture Capital: The Case of Western Australia

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Abstract

This paper examines the process of venture capital and how venture capital investors and entrepreneurs perceive it. Drawing on the findings from a series of in-depth interviews conducted with participants from the venture capital sector and entrepreneurs, the paper examines the case of Western Australia. Findings suggest that the Western Australian venture capital sector's approach to the evaluation of investment opportunities is consistent with that found around the world. However, while Western Australia offers an attractive lifestyle for entrepreneurs, the sector is both immature and poorly coordinated with inadequate networking between investors and entrepreneurs. Recommendations for future strategies are highlighted.

Venture Capital in Western Australia

Western Australia comprises approximately one-third of the national land area, but hosts only 9.9 per cent of the country's total population (ABS, 2002). Its economy is based on a strong mining and natural resources sector, particularly the production of natural gas generated from offshore fields in the state's northwest. In 2001-2002 Western Australia's economy generated 10.6 per cent of the national GDP, a higher per capita ratio than any other state (DTF, 2002). Despite the strong performance of the WA economy, the state remains overly reliant on commodity exports making it vulnerable to global economic trends. It lacks a sufficient level of diversification, particularly into such new industries as information technology (TIAC, 1999) and biotechnology (TIAC, 2000). As a venture capital market, Western Australia is somewhat unique in that small-capitalized listed public companies sometimes referred to as "cash-boxes", have historically been a significant source of venture capital within the state. Within the national context, Western Australia's venture capital sector is smaller and more immature than that of larger states such as New South Wales, Victoria or Queensland, although there is limited performance data available upon which to make meaningful comparisons (Smith, 2000).

Very little data exists on the nature of the venture capital market in Western Australia. The last published report into the nature of venture capital in Western Australia was commissioned by the Australian Stock Exchange (Perth) Limited and the Technology and Industry Advisory Council (TIAC) (Ryan and Davleson 1989). Its main findings were that following the stock market collapse of 1987 the supply of venture capital in Western Australia had evaporated. This was attributed to a loss of investor confidence and competition from high interest rates offered by less risky investment opportunities. Also contributing to the malaise was a low-level of understanding among investors of the long-term nature of venture capital investing, a poor management track record of both venture capital funds and venture capital backed enterprises during the previous decade, and a capital gains tax regime that did not distinguish between short-term and long-term investment. These factors, coupled with the small scale and geographic isolation of the WA venture capital market created significant barriers to new entrepreneurial growth (Ryan and Davleson 1989). Since the 1980s the WA venture capital environment has improved and it is possible to point to a number of success stories such as ERG Ltd (electronic smart card systems), Austal Ships Ltd (high speed aluminium ferries), and Orbital Technologies Ltd (orbital engines, fuel control systems). Nevertheless, many of the concerns raised by Ryan and Davleson (1989) appear relevant today. Further, there remains little available information on the current state of the WA venture capital market. The purpose of this study was to investigate the contemporary nature of venture capital in Western Australia and to identify factors likely to impede or enhance its development.

The Nature of Venture Capital

Venture capital – despite the familiarity of the term – is somewhat difficult to accurately define. One perspective describes it as a 'dynamic' process that adapts and shifts in response to the surrounding environment and changing nature of industry (VCJ, 1987). Another view sees it more as a process involving the investment of financial resources into the business venture at various stages of its development cycle and in which the investor accepts high relative risk in expectation of significant capital gain (Golis, 1998). Venture capital is frequently viewed as relating to a particular class of financial asset associated with unlisted or non-public share capital (Smith, 2000).

The non-public nature of venture capital financing highlights the importance within the venture capital process of the investor. This individual – the Venture Capitalist (VC) – plays a critical, and largely non-financial, role in assisting newly emerging companies grow and develop (British Venture Capital Association, 2001). This non-financial function is a process of screening and monitoring fledgling firms as well as providing financing (Anand and Galetovic, 2000). Whereas the typical investor in a publicly listed company is seeking an income yield that complements capital gain, the VC investor is motivated almost exclusively by capital gain (Wright and Robbie, 1997). Venture Capital is therefore a process involving relatively high risk, due to the fact that the business venture into which the capital is being invested is usually unproven or underdeveloped either in terms of its commercialization or market growth. Further, there is usually no immediate mechanism for the disposal of the investment, as is typical within the public share market. A key element of the venture capital process is the VC investor who adds value to the venture and partly mitigates his or her investment risk by playing an active role in the management of the venture to some degree and in some direct capacity. Their main investment objective is to achieve returns on the investment by capital appreciation. It should be noted that while VC investors are commonly perceived to be professionals managing venture capital funds, the term can also be used to describe any person or corporate entity that makes an investment involving risk and early stage business ventures.

As a process, venture capital financing can be viewed as moving through several distinct stages that broadly equate to the developmental cycle of the business venture that is the recipient of the investment. Each stage usually requires increasing levels of investment and involves differing levels of risk and return. Although there remains some debate within academic circles as to the number of stages within the venture capital process, five distinct stages can be identified, namely: 1) seed; 2) start-up; 3) early expansion; 4) development; and 5) mezzanine (Golis, 1998; Humphrey, 2000). Each stage involves different levels of investment, risk and return, with private investors – 'business angels' – supplying much of the funding for the first two stages (typically up to 2 million), and institutional investors – a Venture Capital Funds (VCF) – funding through to the last three to Initial Public Offer (IPO) (up to 50 million).

The Social-Cultural Nature of Venture Capital

There is considerable evidence to suggest that culture is a major environmental factor in the development of a healthy venture capital market. Hofstede's (1980) cultural dimensions suggest that the more entrepreneurial cultures tend to exhibit low "power distance", low "uncertainty avoidance" and higher degrees of "individualism" and "masculinity". It follows logically that such cultures would be more conducive to the development of a healthy venture capital market. Young and Theys (1999) believe that the culture of the United States is central to the success of its venture capital market, suggesting that American society is more tolerant of risk and business failure than is common within Europe. Societal values that ostracize venture capital investors and entrepreneurs that invest in failed ventures seems to be a core problem in the development of the critical mass required for a meaningful venture capital market. Minniti and Bygrave (2001) suggest that entrepreneurial learning involves developing a cognitive decision making pattern that relies on past experiences, both good and bad. If entrepreneurs and venture capital investors are not able learn from their mistakes and adapt that learning to new ventures because of cultural barriers the industry will not thrive.

In addition to culture, the venture capital process should also be viewed as much from a social as an economic perspective. As noted earlier, there are many angel investors who base their investment decisions on the intrinsic interest they may derive from assisting the development of a particular business venture and its entrepreneurial management (Oats, 2000). Numerous studies have attempted to determine the factors influencing the decision making of VC investors. Shepherd (2000) suggests that the venture capitalist's decision to invest is highly correlated with their assessment of whether the venture will survive using its proposed market entry strategy. By contrast Priem and Harrison (1994) believe that the venture capitalist's espoused criteria does not accurately reflect the actual criteria used to evaluate investments, or at the least does not reflect the importance placed on each of the criteria in the decision process.

Slater (1993) has provided a framework of factors likely to influence VC investment decisions. These involve both economic and social factors working in combination. Among the economic criteria are such issues as the uniqueness of the product, process, technology or associated innovation, how easily the idea can be imitated by rivals, whether the market entry mode is broad or narrow in scope (Low and MacMillan, 1988; Romanelli, 1989), and how rapidly the market will adopt the innovation or diffuse the technology. Of equal importance are the VC investor's perceptions of the overall skill of the business venture's entrepreneurial management team. For example, a management team that appears to lack important industry contacts, credibility with potential customers and specific industry skills and information is likely to be perceived as presenting a higher level of investment risk than one that can provide such reassurance (Shepherd, 2000). Know-who is therefore as important as know-how within venture capital markets. Entrepreneurs and VC investors are engaging in discrete relationships in which the level of intimacy associated with their deal structure is substantially higher than is typical within public share issues. VC investors can assist fledgling companies and novice entrepreneurs by providing strategic guidance through representation on the Board of Directors, serving as mentors for the firm's executive managers, or networking the firm into contact with additional VC investors, specialist and technical support services, prospective customers and suppliers (Bygrave and Timmons, 1992). This social aspect of the venture capital process has been recognized as a critical factor in the development of such dynamic economic regions as Silicon Valley (Kenney, 2001).

Methodology

To examine the nature of the venture capital process within Western Australia a series of semi-structured interviews were undertaken with individuals selected as representing the major VC investor groups. A sample of thirty-five respondents was selected all of whom were based in the state. The sample, although small, was highly representative of WA's relatively small venture capital sector. Respondents included individuals from electronic venture capital matching services, corporate venture capital funds, government agencies, business angel investors, technology-based VC incubators, VCF institutions, VC advisory services, the VC equities market and entrepreneurs who had received VC investment. The interviews were undertaken with two broad objectives. First, to ascertain respondent's perceptions of the process of venture capital financing as it relates to social and economic issues as described in the literature. Second, interviewees were asked to discuss their own unique experiences in the venture capital process and to voice their opinions on any particular issues that they considered critical, such that issues not identified by the existing literature could be exposed. Interviews typically lasted over an hour and involved the examination of a good deal of highly confidential information.

Each interview was undertaken not as a single respondent in a survey, but as a case study following a replication rather than a sampling logic (Yin, 1989). Although data triangulation was limited somewhat by the confidential nature of the subject matter, the small size of the WA venture capital market meant that bias or inaccuracy among any particular respondent could be checked against the perceptions of other respondents who frequently described similar events from their perspectives. Further, many of the institutional and public sector agencies provided sufficient publicly available information to assist this process. A final control of data reliability involved a draft of the findings being returned to each respondent for checking prior to final analysis. Key issues examined in each interview consisted of: 1) respondent attitudes toward new industry development; 2) perceptions of the Western Australian investment culture; 3) VC investor motivations and investment selection criteria;

4) perceptions of the strengths and weaknesses of the venture capital sector in Western Australia.

Findings

Assisting the development of new industries is one of the main roles that venture capital can play within any economy. As noted earlier in this paper, the Western Australian economy is highly dependent on a relatively narrow range of industries such as mining, oil and gas. In recent years a range of new industries have emerged including aquaculture, viticulture and wine making, and marine engineering, particularly the construction of high-speed aluminium vessels. Each of these new industries has attracted a number of small to medium enterprises with good export potential. Respondents viewed the WA economy as possessing several competitive advantages conducive to the success of such new industries. These included a high quality education system, high levels of innovation, good R&D infrastructure, specialist knowledge in agriculture and resources, a clean environment, close proximity to key Asian markets, low labour and real estate costs, and an open socio-economic environment. However, they were equally critical of the State's small local markets, shallow industry base in targeted sectors and immature financial market.

The Western Australian Investment Culture was found to possess both positive and negative attributes. For example, the state enjoys one of the most clean and safe environments in the world with a climate and lifestyle that is conducive to outdoors recreation all year round. This, combined with the relatively low cost of quality housing, makes it a desirable location to achieve a relaxed way of life. There was a general view among respondents that people tend to 'choose' to live in Perth because of its geographical isolation from global business centres and markets and that this 'choice' places an external influence on their business planning. For example, many Western Australian businesses would be undoubtedly better-off if they were located closer to their markets or more robust industry clusters, however, their proprietors choose to live in Western Australia because of lifestyle reasons.

Respondents also believed that the local business culture was a little more forgiving of failure, particularly within the business community itself, because of a local perception that it is relatively more difficult to achieve business success in Western Australia. There was also a general recognition among respondents that the state's business environment is shaped by the entrepreneurial pioneering spirit, particularly in the opening up of the mineral and agricultural resources over recent decades. Both minerals exploration and agriculture involve relatively high levels of risk-oriented investment. It was further acknowledged that as a result of this, most of the private wealth in Western Australia is 'young money' that has been acquired, at the most, over only a few generations and typically derived from entrepreneurial activity. It was suggested that this has resulted in several somewhat conflicting attitudes among the private investment community. One view was that the entrepreneurial source of Western Australian private wealth has perhaps resulted in more adventurous investors and entrepreneurs alike. Another was that the perceived difficulties involved in accumulating wealth in Western Australia has perhaps made some investors and entrepreneurs a little more risk adverse than the first assertion suggests. The geographic isolation of the state capital Perth from other Australian cities was acknowledged as contributing to a perception of isolation from national decision-making. Respondents viewed this isolation as fostering a sense of 'national neglect' in relation to the fostering of local innovation and the mobilisation of venture capital. A strong 'us and them' attitude was identified with respect to west coast versus east coast relationships.

It was generally acknowledged that Perth is a very small and close-knit society where business and social networks are interlinked and overlap. There were also somewhat conflicting views as to the extent of social-class influences. While some interviewees suggested that Perth had a very flat class structure, others contended that social class and the boundaries around certain professions were very evident. They felt that this caused some isolation of participants within the venture capital process. It was noted that significant social differences exist in Western Australia, between most entrepreneurs, the financial and professional community who serve as conduits to venture capital, and university academics and researchers. Given the importance of social networks in entrepreneurial development and VC investing, this was viewed as a problem.

VC-investor motivations and venture selection criteria were found to closely match those mentioned within the literature. Respondents sought “competent and commercially realistic” business plans based on sound market research and logical strategic assessments. A clear and defensible competitive advantage was identified as important; as was the speed of market development, lead time, ownership of intellectual property and past and projected financial performance. Also important were such social issues as the propensity of the entrepreneur to accept advice, the attitudes and reputations of other venture capital partners engaged in the project and the quality of the venture’s corporate governance and management. The VC investors were also interested in opportunities for them to add value through the leveraging of their existing skills and networks. The entrepreneurs who were interviewed for the study also considered the ability of VC investors to add value as important, as well as simple deal structures and an absence of shareholder conflict. They respected the ability of VC investors to assist with advice, networking and strategic planning. This was considered to be of more value than if investors simply wished to monitor their capital gains. Entrepreneurs, and many VC investors, felt that this mentoring or value adding aspect of the relationship was largely absent in the case of Western Australia.

Respondent perceptions of the venture capital sector with Western Australia identified a variety of issues that are worthy of further consideration. It was generally acknowledged that formal venture capital in Western Australia is a very immature and fragmented industry and there is an absence of adequate depth throughout the spectrum. For example, there are no funds that are active investors in early stage ventures, resulting in an absence of a clear funding path for entrepreneurs with an emerging venture. Several respondents expressed concern that innovations generated in universities under public sector research grants were lost due to an absence of commercial integration and funding to develop such projects. Participation at this stage represents a significant challenge to the Western Australian investment community. There was also a perception that early stage venture funds should specialise because the undeveloped nature of the technology which is typical at early stages, and the ‘needle’ markets at which these technologies are often targeted, require specific technical and industry expertise to assess. The deal flow in any one sector in Western Australia is not adequate to support specific funds and as such generalist funds rely on independent experts to assess specialised technologies and markets. However, the use of such independent experts can result in overly risk adverse assessments.

Venture capital funds within Western Australia were also perceived as lacking sufficiently strong track records with which to enable them to market themselves to the private investment sector. Managers of such funds were viewed as relatively inexperienced and possessing largely financial backgrounds, rather than technical or entrepreneurial expertise. The entrepreneurs interviewed for the study were largely unaware of the existence of the formal VCF firms located in the State, a possible reflection of a gap between the formal venture capital industry and entrepreneurial community within Western Australia.

With respect to **corporate venture capital institutions** respondents expressed one of two opposing views. On one side there was support for such investment where technologies are specific and where a substantial capital investment is required to develop and test prototypes. An example given was the development of components for renewable energy sources. In this case corporate venture capital was seen as the only realistic source of financing. A contrary view of corporate venture capital was that the parent firm's strategic intentions in relation to decision-making within the venture were often not in the venture's best commercial interests. The track record of **technology-based VC incubators** within Western Australia is limited, although some examples have recently been established. Despite this lack of proven experience most respondents viewed technology incubators as being a good model for Western Australia because they are a contemporary method of addressing early stage venture requirements and have been proven in more developed jurisdictions.

It seems that **the private or informal venture capital market of 'business angels'** has always played a significant role in the Western Australian venture capital environment. Indeed at times it has been the only source of local venture capital. The general perception among respondents was that the actual and potential angel investor market had grown considerably in Western Australia over the past twenty years. It was estimated that there are currently between two and three hundred high-net-worth individuals in Western Australia that are able to justify high risk investments of a size congruent with early stage venture capital requirements. However, despite the increased size of the business angel market in Western Australia it remains very fragmented and heavily reliant on personal relationships and networks. Furthermore, it was suggested that many angel investors in the state do not actively seek investments. Advisers, associates and friends who have matched the angel investor's specific industry skills or reputation with an opportunity usually present investments to them. It was also noted that some angel investors might be making investments through formal venture capital funds as a result of the emergence of that sector, but the degree to which this might be happening could not be accurately estimated. It was also noted that much of the private wealth in Western Australia has been created in the resources, agriculture and property sectors and as such, subsequent private investment by these individuals tends to be directed toward these sectors. Despite the limited sectors from which private wealth has been derived, private wealth in Western Australia has typically been created from entrepreneurial activity and as such there is a higher than normal propensity for private investors in Western Australia to invest in ventures that involve risk. There were felt to be a number of high-net-worth individuals who had created wealth from entrepreneurial activities, but had now become very conservative investors. It was suggested that this is because they have first hand experience at how difficult it can be to build a successful business in Western Australia.

Government involvement in the venture capital sector was seen by most respondents as beneficial in terms of setting strategic directions for the State's industries and fostering a positive public attitude toward venture investing and entrepreneurship. Government policy could also assist in provision of land for industrial development and to attract major international investment that would establish new infrastructure within the state. Taxation policy and incentives for risk investment, as well as provision of public sector funds for seed and start-up capital was also seen as useful in circumstances where private investment was unavailable. However, the general view of respondents was that the government should not be making private sector investment decisions, but where there is a basic market failure, public sector funding is often needed to stimulate activity. The coupling of public sector monies with private sector investment in schemes were praised as been an excellent mechanism for correcting market inefficiencies. There was general criticism that it was too difficult for entrepreneurs to gain access to government grants in the early stages of the venture when they are needed, however they seem readily available for later stage ventures. Most respondents expressed concerns over what they saw as a lack of clarity in the State Government's policies on industry development. The interviews were undertaken in 2001 following a recent change of government and a major restructure of the State Government Departments. There was concern raised that this restructure may result in innovation and venture capital issues not receiving the attention they require.

With respect to **the stock market**, it was the respondents' perception that the micro-cap end of the Australian Stock Exchange to provide liquidity was somewhat of a misnomer, as any volume tends to evaporate as soon as market sentiment turns sour. It was also noted that promoters of listed companies had excessive expectations relating to the value of a listed vehicle in the case of backdoor listings. In these circumstances the resultant Board of Directors frequently do not possess the skills necessary to provide the best value add to the venture. There is also a danger that some entrepreneurs and promoters adopt an attitude that once the venture is listed that the game is over. For a venture to be funded by the share market it needs to be promoted. However, once market sentiment turns sour on the specific venture, there is pressure to disregard the venture in favour of a more attractive asset.

Conclusions and Policy Recommendations

The U.S. National Commission on Entrepreneurship report into entrepreneurship and its role in developing the new economy highlighted five key factors that are required to facilitate entrepreneurial behaviour within any particular region. These factors are: 1) diversity in sources of venture capital; 2) an enabling culture; 3) the existence of strong local networks; 4) a supportive infrastructure; and 5) an 'entrepreneur friendly' government (NCOE, 2000). As found in this research, the diversity of the venture capital sector in WA remains low with few institutional investors that possess limited track records. While private 'business angel' investors have traditionally played a significant role in the State's VC sector, the potential of this segment remains largely untapped. Problems also exist for small firms in accessing the stock market. Although WA has a positive climate of opportunity that tolerates risk, more recognition and support is needed for ventures that lie outside the traditional mining, resources, property and agriculture sectors.

The strong personalised networks and socio-cultural gap that appears to exist in Western Australia between investors and entrepreneurs arguably represents the single largest barrier to more effective venture capital interaction. The motivations and criteria used to assess each other, highlights the social nature of the venture capital market in Western Australia. This focuses heavily on the individual and it appears that venture capital relationships are not delivering the value-add that they should. There is considerable scope for a relatively neutral party to play a role in improving the socialisation between these groups and bringing parties together in a more transparent and informed environment. Such a role could be undertaken by universities who offer not only a relatively neutral ground for the networking of entrepreneurs and VC-investors, but also provide entrepreneurship education, commercialisation and technology transfer services and research and development support.

Although VC investors in Western Australia appear to follow similar patterns to the selection of investment opportunities as do their counterparts around the world, the small size of the local market and its geographic isolation result in a greater emphasis being placed on the personal relationships between the entrepreneur and other parties involved in the deal. Further, there is a tendency for institutional VCF investors to adopt a 'financial investment' approach to assessing investment opportunities, rather than considering the strategic nature of the business and assessing the value that could be created by a long-term commercialisation or market development process.

Western Australian business ventures and the VC investor community need to benchmark nationally and internationally, and think in terms of selling into national and global markets almost from inception. A more concerted effort needs to be driven by State Government, industry and educators to form links between Western Australian ventures and Eastern States stakeholders. Government policy should be placed on long-term industry development rather than short-term new venture creation. Growth oriented, globally focused entrepreneurial firms will emerge and prosper within the right environment. The challenge will be to create the appropriate conditions by enhancing the level of interaction between the VC investor, entrepreneur and related support networks. Western Australia has insufficient critical mass of all three and must therefore concentrate its resources for best effect.

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