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GOVERNMENT VENTURE CAPITAL DOMINATED
ENTREPRENEURIAL ECOSYSTEM**

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Opportunities for Syndication in a Government Venture Capital Dominated Entrepreneurial Ecosystem

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Abstract

Syndication brings more specialized and domain-specific investors to participate in venture capital investments with local government-sponsored venture capitalists. Local and regional government-sponsored venture capital funds can have difficulty sourcing syndicating investors. This research explores the candid observations of potential syndicating venture capitalists and their likelihood and propensity to invest alongside small regional government-sponsored venture capital funds. Issues relating to the capabilities of local fund managers, valuations, contracting provisions, and the alignment of motives required co-invest together are discussed. The overriding factor that syndicating venture capitalists like to do business with colleagues they have come to trust can limit the local venture capitalists' abilities to leverage the public funding provided by local government-sponsored venture capital funds.

Keywords: syndication, government venture capital, valuation, entrepreneurial ecosystem

Introduction

Syndication is vital for most venture capital-backed firms because of the need for successive waves of increasingly larger finance as the firm rapidly grows. There are three major components in the equation for syndication: the founders, the local VC investors, and outside co-investors invited to participate in financing a deal – the syndicators. The founders sell equity from their newly burgeoning firms to a venture capitalist (VC) and syndicating venture capitalist (SVC) who purchase the equity with capital from the funds that they manage. Syndication is a method to share risk by reducing the amount of investment that must be contributed by each VC, and by allowing the participating funds to include more investments in their portfolio (group of investees financed by a fund), and is a means to validate their decision-making

Most syndicated investments are characterized by two groups: the VC who identified the founder as an attractive opportunity, usually within reasonable

proximity to the founder, and the SVC that the local VC invites to participate in the financing. Isolated locales, or regions bereft of any venture capital often have government interventions to fill financing gaps for founders and their fledgling firms. These government-sponsored venture capitalists (GVC) tend to operate within a specific geography, have no specific domain expertise, nor a specific strategy, and are often saddled with diverse economic objectives such as job creation.

A syndicating VC, however, can originate from anywhere and is invited to participate in the deal by a local GVC. A VC in Chicago that has a specialty in photonics can be invited to participate in a local deal with a GVC because syndicators rely on the local GVC to monitor and provide oversight for any co-investment they might do together. Thus, the geographic range of a syndicator and their money is theoretically limitless.

Syndication fuels the venture capital system. Because one can invite syndicators from around the world, there is essentially an unlimited stock of syndication capital available. Indeed, there are U.S. funds making investments in Asia and European funds making investments in Canada. Someone from the U.K. can invest alongside a local VC to fund a Nova Scotian company (a current situation). With an unlimited number of VCs to work with from around the continent, the stock of syndication funds is vast.

Yet, what is the reality of such deals. The nature of the relationship between local GVC and SVC forms the purpose for this study. The perceptions of SVC as they relate to syndicating with GVC are largely unknown and this explorative study undertakes to identify candid sentiments by SVCs about their interests in participating with local/regional GVC. The research question is relevant because it assesses the impact of the local GVCs relationship building efforts with the potential SVC industry, and it investigates how SVC view local GVC personnel and activities. Their observations could be practically instructive for GVC. Moreover, VCF rationales for their observations give rich context to the quantitative developments in the industry.

The study proceeds with an investigation of the extant research. The methodology for the study follows along with some descriptives of the respondents. The results take the form of the many topics covered by the SVCs forming the results. The paper concludes with a discussion of the findings and limitations of the work.

Extant Research

Regions attempting to develop entrepreneurial economies sometimes create government-sponsored venture capital funds (GVC) to invest in research and development (Cumming 2007) and fill financial gaps (Cohen, Gabbay et al. 2012; Mason and Harrison 2015). Less favoured economic regions embed GVC in order to counteract the tendency for VC to congregate in more metropolitan areas

(Christensen 2007). GVC have different objectives than independent or captive venture capital funds. GVC objectives often limit investments geographically to ensure the funds are invested in the immediate political area (i.e. Myles 2013). GVC investments are then used to leverage other finance (i.e. Humphery-Jenner 2012), referred to as syndication.

Venture capital syndication is financing of a founder that is shared amongst more than one venture capitalist (Bygrave 1987). As a chief method to alleviate adverse selection (selecting poor entrepreneurs), syndication relies principally on the financial need to reduce risk by diversifying their portfolios, as well as to ensure sharing and reciprocity within the industry (Lockett & Wright, 2001). The motives for syndication are more risk sharing in nature than risk reducing. Syndication is a social endorsement practice that reinforces the venture capital network and is a predictor of, and positively associated with, the expectation of risk. Low-innovation projects with lower risks have lower co-investment rates than high innovation projects with higher risks (Bygrave, 1987).

VC prefers to have syndicating partners. In so doing, they can participate in increasingly diverse investment opportunities (Alexy, Block et al. 2012). SVC reduce informational uncertainties by appraising other venture capitalists' willingness to invest (Lerner, 1994). They do this based on the superiority of decisions made when a number of independent observers agree (Sah & Stiglitz, 1986), and by taking advantage of improved information of new syndication partners during follow-on rounds (Admati & Pfleiderer, 1994). Syndication also permits VC to learn improved methods – of say, contracting – that accrue from socialization (Bengtsson and Bernhardt 2014), they benefit from greater added value due to group diversity (Ma, Rhee et al. 2013). Syndication can bring more specialized investors to participate in deals. Some venture capitalists will even reconsider investing in projects that they previously discarded because of the involvement of a particular venture capitalist (Steier & Greenwood, 1995).

VC also exploit informational asymmetries by investing in later rounds of profitable firms to boost their own reputations and returns (Lakonishok, Shleifer, Thaler, & Visney, 1991) so that they do not “*conspicuously under-perform their peers*” (Lerner, 1994, p. 18). Canadian VCF can take advantage of improved exit opportunities if syndicators are cross-border (Espenlaub, Khurshed et al. 2014) originating in the larger US industry.

Early-stage VC or business angel networks (BAN) may even prefer syndication with a larger fund to be preferable to an exit. In these cases, the long run returns from a future exit are expected to be greater than an immediate sale. The original business angel or early-stage VC will stay on as the lead and continue to play a role in advising the investee (Harrison & Mason, 2000; Murray, 1994) while bringing in SVC (Murray, 1994). It is a bit of a double-edged sword, however, because early-stage capitalists have few other options and the larger funds negotiate with that knowledge and the balance of power lays with the new investor even though the

first financier provides the support and specialisation required by the investee (Murray, 1994).

The research question investigates the willingness of private, independent SVC to syndicate with GVCs located in smaller, geographically dis-located regions. This study explores a specific locale, investigating GVC and their relationships with SVC and the perceptions of the latter in engaging with GVC.

Methodology

Investigating the syndicating practices between local GVC firms and SVC took a qualitative exploratory approach. The research question, whether the local GVC had the ability and tools necessary to drive syndicating partners into the local area, was investigated by questioning GVCs' peers outside of the local region. The impact and effectiveness of GVC and its ability to leverage funds from other sources (syndicate) was assessed by broad ranging personal interviews. Fourteen in-depth semi-structured, open-ended interviews were conducted with industry participants from across the continent. These included private and independent venture capitalists, private equity investors, and business angels. The interviews were conducted in a manner supportive of grounded theory. This means that as the interviews are being conducted, the questions evolved, and as new topics and ideas were broached, they became part of the analysis (Fendt and Sachs 2008). The questions advance as new findings about a phenomena unfold.

Fourteen participants were interviewed. All interviews were conducted in the presence of two researchers, and all but two were recorded in full. All respondents were assured of confidentiality and each participant was interviewed for between forty-five minutes to an hour. Their comments were free ranging which were later categorized into three categories: their comments about founders; their comments about GVC specifically and in general; and their comments about syndicators and syndication. This study features the latter two categories, GVC and SVC.

The open ended interviews were complemented by quantitative data analysis. Local data of numerous investments conducted within the region made a quantitative contribution to accompany the comments of the interviewees. The quantitative data were specific term sheet data of 105 GVC investments. This more complicated methodology was used because introducing qualitative material with quantitative data improves the interpretation of observations (Wiersma 1991). Combined, the naturalness of the participants' observations, and stories, along with quantitative data contributes to internal validity of an argument (Smith and Glass 1987).

Participants Selection

The sample for the qualitative interviews was derived from the list of potential syndicating relationships developed by the local GVC. Fifty-two venture capitalists from around the US and Canada were contacted by email to participate in an interview and the scope of research was outlined. Two rounds of the email were distributed. The

respondents whose comments are included in this report were those who volunteered to participate during the short two-week period allotted for these interviews. Concerns by GVC about preserving important relationships were effected by only interviewing respondents who volunteered to participate. No calls were placed to encourage participation.

Respondent Descriptives

There were numerous different types of funds represented by the respondents and not two were identical. Three funds had typical limited partner (LP)–general partner (GP) relationships and they each had different domain specialities. Two business angel organizations and investment clubs from outside the region, and the country, operated on different business models. Two respondents leaned more towards the private equity models, but were in a similar search for growth oriented companies. A corporate (captive) investor and a retail fund investment manager offered to be interviewed. Several investment managers were operating in the U.S. as well as Canada and one former Canadian investor was a serial entrepreneur who had built a very large company.

To present the diversity and breadth of the respondents, their characteristics are presented below in Table 1. These qualities describe the range of characteristics embodied by the investment managers interviewed.

Figure 1 – Respondent Descriptives

- Individuals making investments under the auspices and oversight of a collective
- Syndicators who only lead, and syndicators who never lead
- Typical LP funded and GP organized funds, and business angel network directors
- An investment club that invests up to \$300,000 per investment
- A SVC that characteristically invests \$5,000,000 - \$30,000,000 per investment
- A SVC that offers its incubation and mentoring services on an equity for service basis
- A fund that writes some of the biggest cheques in Canada
- Canadian funds, and American funds
- Controlling interest oriented private equity funds
- Silicon Valley VCs and Ivey League educated VCs
- VCs bred out of the banking industry
- An entrepreneur who built a \$2 billion company turned VC
- VCs who have worked on or advised on IPOs
- Highly successful exit participants
- Early-stage Series A investors, and later-stage Series B and C investors
- VCFs from \$200 million funds
- \$30,000,000 fund managers, and incubators whose money was half of their own.
- Angel investors outside the region, and angel networks outside the country
- Advisory practices for growth stage companies
- A Committee member to the Ontario Securities Commission

- Canadian Venture Capital and Private Equity Association representatives
- Investment managers who have traditionally made Boston financings only
- Investment managers who believe their investments should devolve outside their normal perimeter
- Advisors to capital formation in private markets in mature firms (five to 20 years) and some pre-revenue firms

Results

This section discusses GVC qualities that are related to syndicators' needs. Their opinions were solicited about the nature of valuations in the region and its importance to syndication and their perceptions, if any, of the sense of rivalry or comradery in the industry and its relevance to developing relationships. The skill set of the investing base as part of the value-added that a GVC brings to a syndication were observed.

Regional Awareness

The local area is not widely recognized as a hotbed of VC activity. SVCs varied in their knowledge about the locale; some were well acquainted and had done deals in the region, a few were discerning about it, and others were bereft of much insight into the funds or personalities that ran them. One interviewed fund had U.S. coverage northeast of Washington and was aware of the region as well as some of the local VC funds. Another interviewee has been in the region often, has invested here, and had visited some of the incubator events. He remarked that he does not know everyone in the industry in Nova Scotia, but has a sense of the active funds in the region and his company has someone out here every six months. A third participant said he had looked closely at a technology company in the region at one time, but any other contacts would have been restricted to brief calls with VCs in the area.

A U.S. SVC admitted he had no knowledge of the volume and quality of deal flow, however, he acknowledged the Canadian governments' efforts at bringing companies cross boarder via the Canadian consulate office. A Canadian VC noted, *"Who would they consider their VCs? I only know of two and I couldn't even tell you who they are ... and there was a new fund that started maybe a year ago that I was sort of marginally aware of ... but I don't even really know who they are ... and there were a couple of other groups that do venture stuff but are not funds by trade. So I don't really know who the folks are."*

The key investment manager for an American fund indicated he does half of his financings in Canada representing 40 percent of his capital. He likes to invest in Canada because his reputation provides a competitive advantage. *"In the States, I've only been there for five years. I'm anonymous in the States. But I'm not anonymous in*

Canada; I'm not anonymous in Waterloo particularly. Everybody knows who I am and anybody who wants to do anything, or wants money, has my number." He mentioned Waterloo, Toronto and Montreal connections, and though he has not made any investments in Nova Scotia, but the investor had seen deals from Atlantic Canada.

A domain specialist SVC who knew the province well and the various GVC operating in the region conceded, *"I don't know of any groups in Atlantic Canada that we wouldn't want to deal with. I know the general ecosystem in Atlantic Canada."* On the contrary, even though there is not a fund in Canada that does not know the Radian6 and Q1 Labs deals (New Brunswick), a number of the VCs do not reflect on Atlantic Canada as having a vibrant technology space for deals. One ranked the country in order of importance: Ontario, BC, Quebec, Alberta and the rest of Canada is fifth. *"I spend a day a month in Vancouver, I live in Toronto, Montreal once a month, Calgary twice a year. Teams from here going to the east coast might take place once a year. I have yet to make a trip to Saskatchewan or Manitoba."*

Valuation

In a normal functioning market, the various perturbations of the supply of entrepreneurial equity, and the demand for premium high quality equity by VCs, determines the price. The price, in venture capital vernacular, is referred to as the valuation. If there is an abundance of venture capital demanding to buy the entrepreneurial equity, venture capitalists would jostle cheek by jowl (well maybe not literally) for the opportunity to purchase equity in the founders' firms. This is characterized as a sellers' market (favouring the entrepreneurs) and we would expect the valuation of the firms to be high. This situation benefits the founders.

On the other hand, if there is only a small amount of venture capital demanding to purchase a great supply of entrepreneurial equity, there is more supply than demand and we would expect prices to fall. Entrepreneurs want venture capitalists to purchase their equity, but because there are few VCs, they are able to purchase equity from the best entrepreneurs yet keep the valuations low. This is characterized as a buyers' market and favours the VCs. This is expensive for founders.

Founders in the local region of study think that valuations are lower than major cities. Valuations are often a bone of contention as admitted by almost all participants. Many of the SVCs valuation considerations revolved about the founders, the depth of their capabilities and how they should handle lower valuations. SVCs think founders spend too much time talking about valuation, whereas discussions about strategy are the more important discussions. An investor focussed on Series A investments remarked that the first thing entrepreneurs needed to do was to get *"in front of the best investors and get the best deal."* The best deal could mean selecting the partner with the higher valuation, or securing a better partner with a lower valuation. This investor noted the risk of a down round if the

valuation starts too high. If valuations were too high, the next investors can decrease the valuation and then the founder's company gets the stigma of a *"problem company and the company is then viewed through a negative lens."* This is usually not productive for the company.

One SVC articulated that valuations in Canada are based on a checklist of qualities that a founder accumulates; according to this respondent each quality adds another \$250,000 - \$500,000 to the founder's valuation. Higher margins, recurring revenues, highly profitable revenue streams, multiple products that provide stability, an experienced team with two serial entrepreneurs, and lower fixed costs are all the qualities that contribute to higher valuations. For every one of those boxes that are checked, the investor is paying for a higher valuation.

Another respondent reasoned that if a founder has a prototype, can sell the vision, and articulate the problem that their product is solving, their firm is valued at \$1 million in Atlantic Canada. Whereas, if the same firm were in Silicon Valley, it would likely be valued at \$3 million. He reasoned that when there are so many other firms vying for funding there are more high ability entrepreneurs just due to sheer numbers and that the better ones will be valued higher. Another explained that in Canada, the median valuations are \$2.5 million for angel groups. That includes validated product and validated business model, sales traction and some evidence of sales. If receiving a sufficiently high valuation is a problem for a company they should raise convertible debentures and offer a big discount.

A Series A SVC said the region is less of a focus for the VC industry and there are fewer entrepreneurs and less capital available so valuations are low. *"The stats would probably show there is a discount on valuation in the region."* He quickly noted, *"However, if Jevon MacDonald or Marcel (LeBrun) wanted to raise a company and it was based in Fredericton or Halifax, no one would care. There would be a lineup of people wanting to get into the deal. It wouldn't matter if it was San Francisco valuations or Atlantic Canada valuations."*

A New England angel group's rationale about valuations was similarly rooted in the VC/entrepreneur marketplace dynamics. The respondent noted particularly, *"When you have a huge supply of start-ups and only a little bit of funding to fund them ... If Ross Findlay's group is the only one there to finance it then they're largely determining the economics of the deal, the valuation, the liquidation preference, and things of that nature. In Boston, where there are 100 VC funds and a dozen business angel groups, and you've got a really good company, the competition for that deal is going to put the power in the hands of the CEO of the start-up because he is going to have competing term sheets and he can turn up the valuation till the market will stop bearing it."*

A life sciences SVC said all entrepreneurs think their company is undervalued; there is a general consensus that Canadian companies are valued lower than the U.S. companies that they believe are their equivalents. He succinctly put this notion to rest. He pointed out that the U.S. so-called company *"peer"* will have:

- Likely raised three times as much money already from angels or economic development corporations;
- Done better clinical work because they have had access to more money;
- Tended to have run fuller clinical programs.
- Tended to do more analytical work at a pre-clinical level; and
- Tended to have done much better bench science.
- More deeply protected IP and more clearly thought through, and
- The management team of the U.S. company will be deeper and broader than the Canadian “so-called” peer equivalent.
- Furthermore, it is more likely that the key entrepreneurs in the U.S. firms will have come out of industry and will have deep domain expertise which – it was observed – was less likely for Canadian entrepreneurs in health care and life science spaces.

This SVC says that the U.S. firm has done all the things *“that underpin true value ... If it weren’t true and valuations were so much lower on the east coast, the east coast would have no problem funding every single company that it has in its portfolio. If I could get the same thing for less, I would do that. But I’m not getting the same thing for less, I’m getting something else.”*

A number of SVCs adopted the go-get-it approach whereby founders vigorously pursue the best options for themselves. *“If that means going to the Valley, then go.”* It is of little value for a founder to complain about valuations in Silicon Valley if that money is not available to her. *“It’s about creating category winners and break-out successes. And usually the sort of slicing and dicing of ownership that happens at the early stages of valuations ... if you’re successful in your ultimate mission then everyone’s going to do fine. Sometimes I think in Canada that we’ve had so few big wins, so few inspirational successes, that people focus on what they see around them which are seed rounds and Series A rounds which are really just points in time.”*

Actual GVC Valuations

The previous sub-section considered the comments by SVCs and the methods, means and advice regarding valuations in general. This sub-section considers some GVC’s actual investment valuations. Differences over valuations is the most common reason for potential investment financings to fail.

Table 1 - Mean of Pre-Money Valuation indicates the mean valuation for firms in each of the previous time periods. Since 2003 the mean pre-money valuations have been trending downwards. In 1999 – 2003, pre-money valuations were \$6.6 million, falling to \$5.3 million in 2004 – 2008. The age of the firms is not known which may reflect on the valuation if in earlier years, a greater proportion of more mature firms were available for investment.

Table 1 - Mean of Pre-Money Valuation

Five-Year Span of Activity	N	Minimum	Maximum	Mean
2009 - 2013 Pre-Money Valuation (\$)	22	1,220,588	6,500,000	2,923,853
2004 - 2008 Pre-Money Valuation (\$)	8	456,818	11,919,688	5,260,158
1999 -2003 Pre-Money Valuation (\$)	12	750,000	24,700,000	6,632,278
Pre 1998 Pre-Money Valuation (\$)	4	266667	450000	379,166

For the most recent period, the average pre-money valuation was \$2.923 million. It is not possible to tell whether GVC valuations are significantly lower than other regions in the U.S. or Canada. However, Canadian SVCs' earlier comments about average Canadian valuations seems to be in sync with GVC valuations. GVC valuations do not appear to be significantly lower. Indeed, a number of \$8 million, and \$11 million pre-money valuations took place in the years leading up to the world financial crises in 2008. Not all new investments noted in each period, however, have been assigned a valuation.

Use of Liquidation Preferences

SVCs have found ways to deal successfully with differences in opinion about valuation if it appears that it will be a deal breaker. A logical and fair method to bridge valuation gaps is the liquidation preference. Liquidation preferences are options for a SVC if there are differences of opinion about the company's value. With the introduction of a liquidation preference, the original SVC investment is secured if a liquidation event occurs. It is based on the notion that *"real money in should be real money out - first."* *"It is unfair for the entrepreneur to walk away with millions of dollars and for the investors not to have made a reasonable return, or to have actually lost money"* noted a U.S. VC.

In a liquidation preference example, a VC places a \$500,000 investment in a firm valued at \$5 million taking approximately 9 percent of the company (\$500,000/\$5,500,000). If the firm is later acquired for \$30 million, the liquidation preference returns the VC's \$500,000 first, and then the remaining proceeds are distributed according to the ownership and type of participation. In this example, the VC first receives their \$500,000 (the return of their investment at liquidation) and then nine percent of the remaining \$29,500,000 (if fully participating) for a total

of \$3.155 million (\$2,655,000 + \$500,000) which is 5.3 times the VCs investment (531% return).

In an awkward situation, it is possible for the VC to lose money, but for the entrepreneur to have a very good return. This may happen if the same company in the previous example sold for \$2,500,000 instead of \$30,000,000. In this example, (a real example) the VC placed a \$500,000 investment with a firm valued at a pre-money valuation of \$5 million (without a liquidation preference). Later the company was acquired for only \$2.5 million dollars. In this situation, without a liquidation preference, the VC received \$225,000 (9 percent of \$2.5 million) and lost more than half of their investment (they invested \$500,000 but only received \$225,000). *“The entrepreneur walked away with a \$2.275 million payday.”* The VC lost money, but the entrepreneur was extremely successful. Hence the liquidation preference is used here as a hedge against a valuation for which a VC may feel uncomfortable.

Most recently, the GVC’s activities with respect to liquidation preferences align with the motives outlined by the comments of other seed investors above. In *Table 2 - GVC Liquidation Preference by Pre Money Valuation*, the most recent period’s liquidation preferences can be seen to be applied to investees with much higher mean valuations (2009 – 2013). The liquidation preferences are applied to investees with a mean pre-money valuation of \$4.387 million whereas those without a liquidation preference have a mean pre-money valuation of \$1.911 million. These do not include investments where no valuation was established at the outset.

Table 2 - GVC Liquidation Preference by Pre Money Valuation

Five-Year Span of Activity	Liquidation Preference		Pre Money Valuation (\$)
		n	Mean
2009 - 2013	No	13 ¹	1,910,522
	Yes	9	4,387,555 ²
2004 - 2008	No	3	7,837,633
	Yes	5	3,713,673
1999 -2003	No	10	7,178,734
	Yes	2	3,900,000

¹ An outlier and is removed from the investment data for the 2009 – 2013 sample

² *** Significant p < .01

In a similar vein, the size of the GVC investments is tied to an inclination towards liquidation preferences as well. Table 3 - *GVC Liquidation Preference by Investment Size* demonstrates the larger investments undertaken on behalf of the region are protected from eroding liquidation acquisitions by liquidation preferences. In the most recent history, 2009 – 2013, GVC has included liquidation preferences where larger investment sums were involved. Some liquidation preferences can be used to indicate a return of two or three times the initial investment, but this is not the case with GVC data which issued liquidation preferences at one times the investment only.

Table 3 - GVC Liquidation Preference by Investment Size

Five-Year Span of Activity	Liquidation Preference	N	Investment Mean (\$)
2009 - 2013 ³	No	14	264,285
	Yes	18	483,844 ⁴
2004 - 2008	No	3	186,166
	Yes	21	281,919
1999 -2003	No	14	135,773
	Yes	15	248,656
Pre 1998	No	5	240,000
	Yes	11	231,636

GVC Industry Skill Set

The remarks made about the skills sets of the GVC and the professional community are the subject of this sub-section. Rivalry is discussed amongst the larger and smaller firms across national borders, and a rivalry amongst early stage funds which is contrary to later stage funds, is noted as anti-productive. There were challenges by some SVCs with respect to board composition conducted by GVC whereby boards were seen to be too parochial. Lastly, the contracts for early stage companies were seen to be excessively burdensome and costly.

Cross Border Deals: SVCs indicate that there is more sharing of information amongst later stages funds. The necessity to build relationships and syndicate amongst one another is fundamental and essential, particularly where domain specialization is

³ LightSail is an outlier and is removed from the investment data for the 2009 – 2013 sample

⁴ ** Significant $p < .05$

predominant. The wider SVC community is considered very “clubby” with substantial industry knowledge shared amongst fellow insiders. *“Everyone knows everyone more or less, and everyone talks to one another” “VCs working together, rather than against one another, enhances exits. It improve terms and everyone gets a piece of a variety of deals.”*

SVC indicate that the Canadian industry’s dwindling number of funds presents less competition. This less competitive environment is manifest in deals taking longer to conclude which is not a favourable condition for the industry. In the U.S., *“there is less of a fear of an opportunity getting scooped away from you by other competing investors is lower ... For the Canadian scene to move forward there has to be more intense competition amongst investors to find great deals. More players in the market would help for the chase to the deal.”* There is slack in the Canadian venture capital industry and the brimming U.S. presence is beginning to make itself felt. Increasingly, said a larger fund investor, numerous American firms are prepared to cross the border for the right deal. *“If a Tier 1 firm out of the U.S. wants to do a deal in Canada, even the larger Canadian firms probably do not stand a chance.”*

The somewhat relaxed competitive rivalry does not exist for seed and early stage funds. GVC operating geographically-focussed seed and early stage funds indicate that there is not a great deal of discussion amongst local fund managers. One investor reported that the local GVCs stay in their niche. They have to because they cannot cross borders. Said one local non-GVC investor, *“We talk to them because we have to, but they do not have to talk to us. The territorial interprovincial bantering about VCs and accelerators stealing one another’s entrepreneurs is just starting to stop.”* Recently, a cooperative effort to develop syndication relationship-building took place amongst non-government and GVC funds, and the shared event was well received by SVCs though not well-attended.

SVC investors report that there is a sense of intense competition and a natural rivalry amongst early stage investors unless an entrepreneur forces two funds together. Said a SVC from a larger fund, *“In Canada, I’ve been sitting at the same table at a conference with people I know and they’re super guarded about what they looking at and what they’re interested in, and it’s sort of fascinating to me.”*

Creating Boards of Directors: Helping the founder create a board is an important role for the venture capital industry. SVCs complain that boards are not as sophisticated as they ought to be in the Canadian GVC industry (as well as within the junior public equity space). Building good boards is challenging because the people who are recruited assume high workloads. Domain-focused SVCs (rather than generalists GVCs) have an advantage in selecting boards because they need to travel further afield to find their deals and the partners necessary to bring the right team and syndicate together. The effort produces knowledge of experts for boards. In order to develop relationships to identify the best syndicating partners, domain experts constantly manage networks cultivated from a very diverse group of

Americans and Canadians which helps them create expert specialist board members.

Domain experience is an asset on a board and is provided by someone with experience in selling into the firms' key markets. These domain specialists understand the key people in the market, the sales process (not technical), how the technology can be applied, and how to most effectively speak to potential sales partners and customers. An effective domain director will ideally have the proverbial Rolodex (numerous well-connected contacts) as well. A properly functioning board member need to give time to the firm, not just their names and biography. Unfortunately such members are difficult to find.

SVCs noted that board composition practices of some of the GVCs are parochial. *"From an early stage perspective, the two problems that you would have are: founders that want to be protective and so they try to have board members who are friends to them as opposed to being completely objective; or, venture capital firms that don't have a whole lot of experience and may not think about trying to attract the best. Take ... or ..., my sense is they don't go out of their way to try to attract the best people wherever they are – I just haven't seen that with them. I think those are the two issues that exist in the region."*

Concerns are expressed that boards are not sufficiently broad-based, geographically or industry-wise, and that persons with intelligent insight into the key markets are missing. The company, hampered by poor board selection, suffers under bad governance. Boards can micro manage firms and meddle in situations causing later down rounds. *"Governance issues arise when populating a board if I have one of these angel guys, one of these government guys, one of these private investors who does not have a lot of knowledge, now I have two thirds of the board who are not productive towards the long term goals of the company."* Having dealt with such a situation, an SVC remarked that these circumstances did not cloud his interest in the region; it simply caused him to search for these potential problems in advance.

Other SVCs focussed on contracting details that were too complex, lengthy and expensive. One example was the documentation prepared by professionals which was excessive based on the size and stage of the company, and more suitable for a large publicly traded firm. The respondent indicated that this over-papering of a deal was likely the result of a professional advisor trying to use standardized documentation; they *"pulled all the terms and conditions and applied them to an early stage firm."* The SVC estimated the documentation would have been indefensible regardless because the entrepreneurial firm did not have enough money to even have the documents read should any action have taken place. The local professional community and GVCs were further indicted for other problems such as the length of the documentation (90 pages), length of time to acquire documentation (twice as long as it should have taken), the lengths to which professional support were sought (legal firms that are thousands of miles away), and the amount it ultimately cost (twice as much).

Generalists (GVC) and Domain Specialists (SVC)

This section investigates the candid SVC comments regarding movement of financing from generalists (GVC) to domain specialists (SVC) and the types of syndication partners that are preferred. Founders' firms move from generalist venture capital funds to domain specialist funds as their financing needs grow. As a founder firm matures, and its capital and mentorship needs expand, the requirement for more specialized financial talent takes the search for venture capital out of the investee's region. Larger venture capital industry funds, more sophisticated domain specialists, or companies that are in the investees' market or industry, understand what the investee is doing better than a generalist.

Responding participants indicated that GVC fund managers were principally generalists because they are geographically focussed and cannot move outside their geography. *"Categorically, if you have local investors who have never invested outside of a geography, they are heads down and myopic to the rest of the world. And so their network is what it is. They understand their small pond very well."* They have to, it is their role. Hence, it is difficult for these generalists to know the specifics of some technologies. A generalist, because they do not fully know the capacity of every innovation, necessarily prices entrepreneurial offerings lower than specialists. Deal terms can become very specific to a region.

As the venture capital industry moves upmarket, so does its sophistication. Various SVC funds gather domain specialties usually based on the backgrounds of their GPs and staff. One fund has five PhDs, a MD, and two others who have been in this industry for two decades. Furthermore, all of these individuals have backgrounds in operating companies and none came out of *"a finance degree into the VC industry."* This trend out of the U.S. is changing the Canadian industry as well; the make-up of the fund managers is much more mimicking the U.S. model.

When an investee finds an investment fund that understands what the technology can do and understands the founder's vision and the specifics of the market, the investee and its local VCs have found what the industry refers to as *smart money*. A SVC quipped: *"...in these instances, the founder does not have to tell the investor what the product will do – the investor will tell the founder what the product can do."* One SVC noted that eventually founders need specialists who can: help the CEO get close to a potential customer; have someone to help them if they need to talk to someone in California; have a tie to someone who can make that connection; help tease out human resource issues; find talent; and spend time with the CEO. These can be all separate individuals requiring the syndicate's fund partners to have myriad resources to draw upon.

Alignment of Motives and Stages for Syndicating Partners

SVC have a variety of operational knowledge and strategic qualities that make them sought after by GVC. These qualities typically involve similar motivations and fund values, the network of relationships that they bring to the syndicate for potential

exit partners and to add value with the entrepreneur, capabilities with hiring talent if necessary, and their ability to provide follow-on financing as the firm matures.

Syndicates gather around a specific investment mentality - never go into an investment alone. The simple rule is that the more deal syndication involved the more validation it provides for the SVC. One VC noted, *"I never go alone, I don't believe in it. It's a sobriety test for me. If no one else is interested chances are I've missed something."* Some funds syndicate on every deal, and are the lead architects of every syndicate they participate in. Amongst these, there are a variety of "sweet spots," with most of them varying around the revenue status of the firm (i.e. just pre-revenue, post-revenue, etc.). Alternatively, a few smaller and seed funds that were interviewed, including an American fund, operate differently; they always syndicate but never lead. Sometimes they are aligned more closely with the founders rather than the future syndicating partners. As seed funds, one investor indicated they often opt out at the Series A level where syndicators need to be harnessed.

One of the largest funds that participated in the interviews indicated that they are sought after for syndication about half of the time, and the other half of the time they are soliciting syndications. In particular, the interviewee noted, large funds writing large cheques and participating in large deals definitely seek participation from *"far more sophisticated investors from south of the border."* He noted as an example, large infrastructure deals where a partner is sought that knows big processes, or plant-type businesses, or has expertise related to infrastructure investments for further fund raising; they look for parties who have other partners, relationships, good optics for a particular deal, or specific contracting experience. Having conversations outside Canada was critical to achieving these partnerships. If the relationships are not built on several previous trials or attempts, they may not be there for you when you need them on a later deal. More capital is always better than less, and strong relationships with capital providers is critical to securing funds when necessary.

SVC stress the similar values that must be shared amongst syndicating partners. The selection of a syndicating partner needs to ensure the alignment of motivations and values such as whether or not they are management friendly or will they hold managements' feet to the fire? A \$200-million fund investor is interested in smart partners who have domain expertise. He said:

"What I'm really looking for is who the partner on the deal is going to be. Is that partner smart, and is he accretive to our totally syndicate strategy. Does that partner have a skill set, an aptitude, an experience base, a set of contact numbers or relationships that are incremental to those that we feel already exist in the syndicate that has been architected. We will very rarely bring a partner to a syndicate that's just dumb money. We might if it was a small amount. But that's not what we're looking for. We're looking for partners who are smart, they know what they're doing, who have domain expertise and they have capital to follow-on so that they can ride the continuum of the company with us, and not force us to make decisions that

are not aligned with how we see value creation. And they share our vision of what value creation looks like. We have to be very careful when we syndicate that we invest with people who have the same end points and objectives as us.

Most of All, It Is the Person

The alignment of motives, stages, and series of investment are all objectives being sought by VCs for syndication. More than that, however, VCs like doing deals with the same person whenever they can. This predilection was repeated over and over in a variety of different anecdotes about their syndication preferences. Three vignettes describe these interests pursued by SVCs.

An SVC from a fund with numerous recent exits prefers to syndicate with repeat partners from previous deals. His fund knows the partner well, they know what they are strong at, they know what they are weak at, they know their style, and they know how the other VC (GVC or SVC) interacts with management. Knowing these elements in advance, by working with repeat partners, reduces the risk in the syndicating partner selection decision process because of the timelines which need to be adhered to for typical funds.

A domain specialist SVC who happened to know the locale and the GVC industry well said, *"I would syndicate with people we have worked with before. And I can say to guys, 'You are going to love these guys, they bring real value to the table.' ... we're different because we've been doing it long enough. We like to cut with our own friends."*

An American SVC recognized that his domain specialty came from his considerable expertise as a founder. He took a derisive attitude about SVC fund managers who, as professional intermediaries, invest other peoples' money and who want to raise larger and larger funds for greater prestige. As a job, their role is to make a good return for their LPs, but in sum it is a job for them. His thrill of the hunt is to make money from his own money and to provide *smart money* in the process. He has syndicated with OMERS and Sequoia, but the entrepreneur is usually the architect who wants him on the deal. His value to the founders and the large well-known funds is his background in business. Having started a business from zero and growing it to \$ 2 billion has given him experience and troubleshooting capability that *"professional VCs"* alone cannot provide.

The importance of repeated relationships with specific people is evident in various successful start-ups, investments, syndications and exits by a collection of individuals in the region. The co-mingling – over more than a decade -- of the personalities associated amongst a corporate entity, a high performing growing firms, several smaller entrepreneurial firms, several successful exits, an IPO, an investment club, and a small number of VCs could challenge a good anthropologist.

Over a decade many of the same names have reappeared on boards, in syndicates and in the ventures themselves.

Trends Affecting Syndicating Partners

The track record for raising new funds in Canada is dismal. Fundraisings are down for private independent funds by 51 percent year over year, and down 24 percent for the industry as a whole (2014). Even the *successful* independent funds are having trouble raising new money. This is particularly troublesome for the east because the fewer funds there are in Canada as a whole, the fewer SVC there are for future financings for GVC. A specific number of funds which were particularly favourable to the local area are having fundraising difficulties. Even a small \$500,000,000 fund could not be raised by a very successful group of VCs. *“These were highly successful people with small shops of only three to five persons.”* The inability of SVC that were once friendly to the region to raise new funds is a loss to the region. *“Previously, there had been some success with mid- to small-size funds where the individuals have a good track record of supporting their investments. But there are very not that many of them left. It’s a very sad day,”* noted one investor.

A few super angels in the region have established funds but they are not ICT, life sciences, clean tech, or ocean tech focused. These newer funds are more private equity-based and are investing in up-market firms (more mature with earnings) in traditional industries because that is what their LPs know. There was some excitement when a very large SVC established a new fund and had articulated an objective to invest down-market into more seed and pre-revenue companies. *“They made one investment and then went up-market again to more private equity deals because the returns were looking much better.”*

Look to the U.S.

Though fundraising opportunities are declining in Canada, they are increasing in the U.S. (Veghte and Herman 2014) where the rate of fund raising is experiencing heated activity. These trends indicate we must increasingly look to the U.S. for future syndicating opportunities⁵. Fortunately, U.S. funds suggest the Canadian market is ripe for syndication consideration.

The leadership of one of the 23 different business angel groups in New England said their group had raised five funds to date and though they have never been approached to invest in the regions’ by the GVC, they appear to be willing to consider Canadian possibilities. The New England BAN noted their sweet spot was just pre-revenue. They had two approaches when seeking their own syndicators. If a deal was seeking to raise \$1,000,000 - \$1,500,000 they had several “pre-existing relationships with SVC regular angel groups that they approach who like to work with to fill out a round. When founders need \$2,500,000 - \$3,000,000, the angel

⁵ Fundraisings are down for private independent funds by 51 percent year over year, and down 24 percent for the industry as a whole. Even the *successful* independent funds are having trouble raising new money.

group goes to the broader set of SVC in New England that are beyond their regular familiar syndicating partners. They have a regular presentation, screening and selection process that takes place twice annually for these larger deals. The many BAN in New England have developed a Due Diligence Treaty to enhance their trust and cooperation.

The U.S. National Capital Association has two initiatives to create broad syndication participation in clean tech and life sciences. Founders who cannot raise enough funds for more expensive deals can access national participation by BAN syndicating from across the U.S. This most recent development of a national business angel syndication structure might encourage them to look at Canadian investments because:

- The real lack of capital for Canadian firms suggests their angel network will find better opportunities;
- They expect that there are more reasonable valuations than in the current red hot Massachusetts market; and
- The Canadian governments' support for entrepreneurship is better than in Massachusetts where there is no governmental support for entrepreneurship.

GVC Syndication

The need for the GVC is crucial precisely because trends in the industry are tending to move up-market, post-revenue, and toward more central and urban areas. *"... Federal funds don't like pre-revenue. It is very hard to get any SVC from out of the region to invest in a company pre-revenue." "It (GVC) adds a lot of ingredients into the ecosystem and I view these funds are absolutely critical ... are far less critical in Boston, or New York, or San Francisco."*

The ability of the GVC to syndicate with partners outside of their own kind indicates the enthusiasm that SVC share in the investment climate in the east coast. *Table 4 – Number of Syndicating Investors* examines the objective data of the GVC's syndication partners over the pre-defined periods. Over the three dominant five-year periods of GVC history in the data, 41.2 to 45.8 percent of the total number of investments were syndicated (barring the pre-1998 group). Looking specifically at the most recent of the five-year periods, the proportion of investments with syndicating partners is approximately 41.2 percent. A couple of investments included two and three other co-investors and one had four syndicating investors in the financing. The slowdown in syndication activity between 2004-2008 and 2009-2014 may have been a result of the rapid increase in investment activity over the two periods (from 24 investments to 34 investments).

Sixteen different SVCs were a part of the 39 deals syndicated since 1998. Troublingly, three of the 16 different syndicators are no longer in existence. A review of the various SVCs concluded that GVC organizations co-invested only on

five of the 39 syndicated investments. In each of these occasions, there were other SVCs in the financing. At least four of the financings had corporate partners as part of the syndicate.

Table 4 – Number of Syndicating Investors

Five-Year Span of Activity		Frequency	Valid Percent
2009 - 2013	GVC	20	58.8
	One Syndicating Investor	10	29.4
	Two Syndicating Investors	1	2.9
	Three Syndicating Investors	3	8.8
	Total	34	100.0
2004 - 2008	GVC	13	54.2
	One Syndicating Investor	7	29.2
	Two Syndicating Investors	2	8.3
	Three Syndicating Investors	2	8.3
	Total	24	100.0
1999 -2003	GVC	16	55.2
	One Syndicating Investor	7	24.1
	Two Syndicating Investors	4	13.8
	Three Syndicating Investors	2	6.9
	Total	29	100.0
Pre 1998	GVC	16	94.1
	Two Syndicating Investors	1	5.9
	Total	17	100.0

The sum of GVC funds invested over the four periods, \$31,897,005, is part of total investments of \$92,086,924. The GVC investments have been leveraged by additional syndication of \$60,189,919.

Table 5 - Amount and Rate of GVC Syndication outlines the additional syndication participation with GVC investments. In the most recent period, every dollar invested by GVC raised an additional \$1.77 for a total of \$2.77 invested in local founders. In 2004 – 2008, 2.88 times investment was raised, and the previous period raised 4.43 times the GVC investments. In total, the additional \$60.189 million invested in local founders was raised from SVC outside the region.

Table 5 - Amount and Rate of GVC Syndication

Five-Year Span of Activity		N	Sum
2009 - 2014	GVC Investment (\$)	34	14,526,749
	Total Raise (\$)		40,424,912
	Times Investment Raised		2.77 X
2004 - 2008	GVC Investment (\$)	24	6,478,804
	Total Raise (\$)		18,454,239
	Times Investment Raised		2.85 X
1999 -2003	GVC Investment (\$)	29	5,630,672
	Total Raise (\$)		24,946,994
	Times Investment Raised		4.43 X
Pre 1998	GVC Investment (\$)	17	3,760,779
	Total Raise (\$)		4,260,779
	Times Investment Raised		1.13 X

Discussion

This research sought to explore the perceptions of local and regional GVCs from the vantage point of potential syndicating venture capitalists. The in-depth interviews with national and international SVCs were combined with data from local GVCs from the Canadian east coast. The rich narrative from the SVCs themselves represents a candid and forthright contribution that adds to the received research to date. Their voice and their brusqueness is vivid.

The discussion draws attention to the need for GVC because of the lack of other available potential syndicating relationships with VCs from outside the region and increasingly outside the country. The nature of the VC asset class is such that without highly qualified local VCs to identify, introduce and monitor founding firms, the potential for syndication is severely curtailed. Syndicators are most likely more specialized domain expertise and are further afield. They will only be introduced to the area if they have local and GVC and VC to provide oversight.

If they wish to be funded in their own locales, founders and their initial investors, friends and family need to work with locally-backed seed and early-stage funds because more formal venture capital funds (larger traditional structures with LPs and institutional funding) have little appetite to syndicate with pre-revenue founders.

Information economics (Akerlof 1970) would suggest that because SVC are industry specific or have domain experience, they have the knowledge and talent to understand the specifics of a technology, can make accurate valuation assessment and can value deals higher. Domain experience is knowledge, experience, and competence in a specific market or industry. A generalist GVC may not fully appreciate how capable is an industry-specific founder's product because the GVC does not have specific domain experience. Therefore, generalist GVCs have less ability to make an accurate assessment and tend to keep valuations low.

Unintentionally, keeping valuations low has the perverse effect of driving away the best founders, those who can go elsewhere for finance, or who can redirect their efforts, or who can postpone their activities until other finance becomes available. Deliberately or inadvertently driving down valuations often leaves the weakest and the least competent founders as the remaining candidate pool. Less capable founders have fewer other options and are willing to accept poorer terms (i.e. lower valuations).

Comments by SVC are aligned with this hypothesis. Moreover, some local founders have balked at the valuations suggested by local funds and have bootstrapped their way to successful exit, or gone to major cities in the U.S. and Canada for finance. In these cases, GVC have lost out on potentially profitable investments and exits. This, of course, happens to every VC. It was noted that *"every good VC does a retrospective analysis every year to investigate the ones that got away. What was on their A list and where are they now? In reality, we see 500 deals a year and we only do five."* Valuations as presented by SVCs seemed in concert with the valuations indicated by the 105-case GVC database.

The proclivity of GVCs to pursue strategies adopted by other seed stage and growth investors infer the professionalization of the GVC investment managers and their protection of the public's funds similar to strategies used by SVC. The inclinations indicated by liquidation preferences indicate GVC practices that protect the investment when valuations are uncertain.

The qualities sought of syndicating partners include alignment of motivations, increasing domain expertise, and SVC capable of pursuing follow-on financing as founders' firms mature. Most of all, SVCs are concerned about conducting transactions with individuals they like to work with and who bring value to the syndicate. Often SVC have a small number of other SVC they go to with syndicating opportunities. Relationship-building is paramount and individual personalities, capabilities and methods are important.

As the preference for specific partners is carried throughout a SVC career and subsequent funds they raise, it suggests that the number of different persons with whom they will do business will (proportionate to the number of deals they do) shrink over time. Therefore, local GVCs will want to source good deals to bring in good syndicators to ensure a repeated series of successful syndications over time.

To do so the VCs must be high value-added contributors themselves. More skilful venture capitalists will have superior sources for deals (Amit et al., 1998) which exposes them to opportunities to produce superior returns. Improving one's investing skill promotes reputation capital and subsequent potential for future syndication (Lockett & Wright, 2001).

The local GVC funds' database demonstrate indicate a good proportion of syndicating relationships in the investments made over the past two decades. In the most recent periods, they have been able to almost triple the amount of investments they have placed, bringing in funds at a rate of and additional \$1.77 for every dollar they invest. Sadly, the Canadian industry is flagging and three of the SVCs that GVC formerly participated are no longer in the industry. More vigilance by GVC will be required to sustain the entrepreneurial ecosystem that the region has begun to rely upon for innovation.

In a perfect world, a local VC finds high performing entrepreneurs from whom to purchase equity and the local VCs then invite others to share in the deal. The syndicating partners do not have to be within geographic proximity to the entrepreneur because they rely on the local GVC to assume the responsibility of providing oversight. GVCs invite potential syndicators into deals because they want to distribute risk and the domain expertise of the SVC will add value. But they also invite SVC to participate in hopes that they will return the favour - that the SVC will invite a GVC to syndicate on one of their transactions in the future. Reciprocity is highly implicated in syndication and trusting (Wright and Lockett, 2003) that a SVC will not act on another's information gathering continues the good standing of an SVC in the industry (Anand & Galetovic, 2000).

AGVC who is soliciting other syndicating VCs (the architect of the deal), can invite any other VC in the world to syndicate with them. Given a highly valuable entrepreneur, a generalist GVC, can select one or two, or three, of the most highly specialized VCs in the world to participate in a deal. With a valuable founder, the potential for syndication is almost limitless.

This is not a perfect world, however. The ability to access, assess, and mentor high performing entrepreneurs can be elusive. Moreover, if SVC like to do business with people with whom they have done business with before, then in reality, the potential billions of dollars in the rest of Canada, the US, Europe and beyond, are largely beyond the grasp of a regional locale.

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