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Closing the 'Equity Gap' in Startup Investments in Information Technology Ventures: The Israeli Experience

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Closing the 'Equity Gap' in Startup Investments in Information Technology Ventures: The Israeli Experience

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Abstract
This article seeks to explain how EIR programs help Israeli VC firms maintain high levels of investment in startup firms in the information and communication technology (ICT) industry, effectively overcoming the equity gap that favors established entrepreneurial ventures. The equity gap arises from the perception among VCs that the higher transaction and monitoring costs associated with startup/seed ventures makes investment in them uneconomic. The research investigated how participants view the value of EIR programs and how trust and control influence the VC decision to invest. Data were collected from qualitative research interviews conducted with VC entrepreneurs and executives who participate in EIR programs in the ICT industry, primarily in the Dan Area in central Israel (considered to be that countryâ s equivalent of Silicon Valley). The findings indicated that EIR programs promote the likelihood of VC investment because they raise what we call the "confidence coefficient" the VCâ s confidence in the entrepreneurâ s intention and ability to deliver the dealâ s return on investment?by increasing various types of trust (goodwill trust and competence trust) and control (most importantly social control), thereby mitigating the perceived risks that comprise the equity gap.

Keywords: Entrepreneur in Residence, Entrepreneurship, Venture Capital, Startup, Seed Funding, Angel Investing, Confidence, Trust

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Introduction

Venture Capital (VC) has proven to be one of the most capital efficient mechanisms for building new businesses and creating jobs in Israel's information and communication technology (ICT) field (Myre, 2005). Since 1995, the Israeli economy has experienced an inflow of $43 billion in ICT investments—$16 billion from VC investments, $20 billion from the ventures' proceeds and $7 billion through VC-backed initial public offerings or IPOs (IVA 2005 Yearbook).

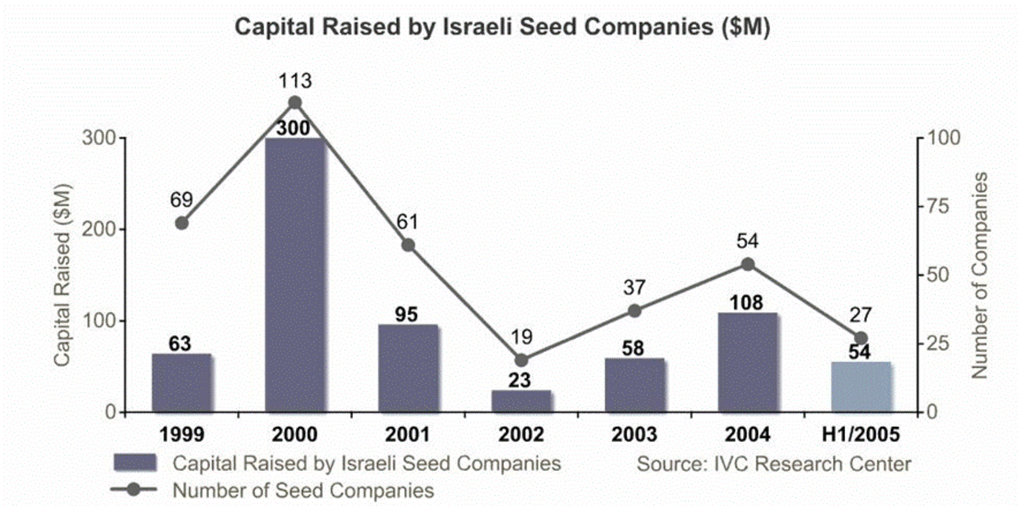

Figure 1. Capital raised by Israeli seed companies

During the first half of 2005, Israeli VCs invested 7 percent of their total available funds in ICT startup/seed ventures. In contrast, Silicon Valley VCs shunned startup/seed ventures and invested only 0.1 percent of total available funds during the same time frame (Table 1).

Shunning startup/seed ventures is a phenomenon called *equity gap*. The equity gap arises from the perception that high transactional and monitoring costs associated with startup/seed ventures make them unattractive (uneconomic) for investment.

Because VCs favor ventures in later stages of development that can demonstrate positive marketing and financial history, startup ventures with no previous performance history are disadvantaged (Table 1). In the United States, this financing gap exists for entrepreneurs seeking between $500,000 and $1,500,000 (Alvarez and others, 1997). Such an equity gap is also present in many other countries including the UK (Mason, 1996) and in Israel on a smaller scale.

Israeli VC funds have always recognized the importance of a portfolio with a significant amount of startup/seed ventures (Figure 1 and Table 1) and, after the high-tech "bubble" burst in 2001, have resumed investment in startup/seed programs. This new investment wave is influenced by Entrepreneur/Executive in Residency (EIR) programs and the Israeli government's risk-reducing programs.

Venture Capital Investment in start-up/seed ICT companies

ISRAEL			YEAR	SILICON VALLEY		
# deals	$M USD	% total		# deals	$M USD	% total
69	$63	5.0%	1999	284	$1,341	7.0%
113	$300	10.0%	2000	186	$869	3.0%
61	$95	5.0%	2001	73	$196	1.0%
19	$23	2.0%	2002	37	$102	0.4%
37	$58	6.0%	2003	54	$139	0.7%
54	$108	8.0%	2004	37	$127	0.8%
27	$54	7.0%	H1 2005	7	$9	0.1%
from IVC and Moneytree Surveys						

Table 1. Venture capital investment in start-up/seed ICT companies

Research Overview

This article examines how the equity gap obstacle can be cleared with EIR programs. Specifically, it discusses how factors such as trust and control combine to shape the perceived transaction and monitoring costs that comprise the equity gap, thus influencing a VC's decision to invest in a startup ICT venture.

The research is based on qualitative interviews conducted with VC entrepreneurs and executives in the ICT industry who participate in EIR programs, primarily in the Dan Area in central Israel (that country's equivalent of Silicon Valley). The qualitative analysis helps us to understand the connections between three constructs of control (behavior, output and social) and two constructs of trust (competence and goodwill) that contribute to the perceived transaction and monitoring costs that VCs consider before deciding to invest.

Findings and Implications

The findings indicate that by increasing various types of trust and control — and thus mitigating the perceived risks that comprise the equity gap — EIR programs raise what we call the "confidence coefficient," or the VC's confidence in the entrepreneur's intention and ability to deliver the deal's return on investment. This promotes the likelihood that the VC will fund the startup venture.

This study has implications for addressing a relatively new phenomenon: the tendency of VC firms in the United States and the European Union to concentrate on larger and larger deals and, as a result, fail to adequately fund early-stage ventures. If left unchecked, this could threaten to derail ICT entrepreneurism. The knowledge presented in this article can be used to help practitioners launch new EIR programs or improve existing programs, and to help academicians shape further research on the VC equity gap.

Literature Review

The field of entrepreneurship research is full of studies about the entrepreneur as the most important player in new venture creation. The contemporary view is that entrepreneurs are driven by motivational forces outside the strict orientation of market capitalism (McDaniel 2005). Entrepreneurs are not the risk bearers (Schumpeter, 1934); their function is to innovate (Acs. et.

al. 2005). Entrepreneurs are driven by pecuniary profits (payment for efforts) and not capitalistic profit motivation (McDaniel 2005). Risk bearing is the function of the capitalist who lends his money to the entrepreneur (Schumpeter, 1934; Acs. et. al. 2005). Access to equity capital, not credit, is the major financial obstacle for the entrepreneur (Van Osnabrugge & Robinson, 2000). Entrepreneurial firms, especially those in the startup/seed stage, need high-risk, patient, value-added equity financing. In other words, they need venture capital (VC).

The idea that talented entrepreneurs are scarce (Knight, 1921; Schumpeter, 1934) has been around for a long time, but the realization that talented, knowledgeable, savvy, VC investment managers are also scarce and central to the ICT startup/seed venture industry is new. In Israel, the high-tech industry and the equity financing institutions – venture capital funds – share an interdependent history. At the center of this research are questions designed to understand VC equity investment managers' decision-making processes and the programs, such as EIR programs, that influence those processes.

EIR Programs

Entrepreneur/Executive in Residence (EIR) programs are internship programs found primarily in Israeli VC firms that are interested in investing in ICT startups (and, to a lesser degree, in Israeli offices of US-based VC funds). The EIR programs have been around for some time, but as competition for repeat entrepreneurs has grown feverish, Israeli VC ventures are relying on it more and more (IVC 5/2005).

Startup/seed Stage: the entrepreneur has only a concept for a potentially profitable business opportunity that still has to be developed and proven.
Early Stage: the newly formed venture is completing product development and initial marketing plans.
Mezzanine Stage: the venture is usually expanding, producing and delivering products and services.
Later or Expansion Stage: the venture is mature, profitable and expanding. It may go public within a year.

Adapted from Sohl, 1999

Table 2. Stages of venture development

VC partners use Entrepreneur/Executive in Residency (EIR) programs to enlist both ideas and people asynchronously in what they call a "deal." A *deal* involves the simultaneous connection of the right entrepreneurial team, the right idea/vision, the right ICT technological market conditions and the right amount of forecasted valuation growth for the new venture.

Entrepreneurs and executives chosen for the EIR programs usually have been involved in a number of startups and, more often than not, have succeeded by taking their ventures public or selling them to larger firms. Whatever the case may be, they are considered to have "high status" in their particular fields of knowledge. Executives in Residency have achieved this status based on their managerial experience while Entrepreneurs in Residency earned their status based on technological and innovation experience. In other words, an EIR has an outstanding record of accomplishment (as either an executive or technologist) and joins a VC partnership as an interim step to his next venture.

The EIR program is designed to provide entrepreneurs with the networks, resources and tools to identify emerging market segments and business opportunities. In some VCs, EIRs act as consultants who specialize in particular industries and can add significant value in terms of screening entrepreneurs who pitch to VCs for startup/seed financing.

Entrepreneurs/Executives in Residence always play a role in the VC prior to start of the venture. Not all entrepreneurs have a previously well-defined concept to the point where it is ripe for investment; some do not have a concept at all. However, all are expected to incubate an idea while receiving a salary and/or market research support from the VC. Eventually he/she will form his/her own venture, or join a team which the VC will fund.

The fact that the EIR conducts his/her work in the VC offices and may also have other dealings with the partners no doubt influences the new venture's concept. Hoffman & Blakely (1987) found that a commitment of employment from the VC positively affected the earlier stages of the relationship.

Israel's Entrepreneur/Executive in Residence programs are based on the VCs' need to better predict through variegated experience of individuals the *how*, *why*, *when* and *where* of their new successful innovative venture. Venture capital executives assert that the ventures associated with an EIR program will sell for a higher price (Jacobius, 2004) when it comes time for the venture capitalist to exit the deal (venture).

VCs mostly use the EIR programs to buffer the asynchronous stages of a deal creation. In a perfect deal, the entrepreneur walks in with a great team, great idea and at just the best time in the marketplace. Statistically, this is an extremely rare occurrence. To ensure that startup/seed stage ventures are worthy of investment, the VCs typically manipulate the deal. When the vision is less than perfect, they use an Entrepreneur in Residency to improve the idea; when the team is less than perfect, they use an Executive in Residency to manage and monitor the venture (Figure 1).

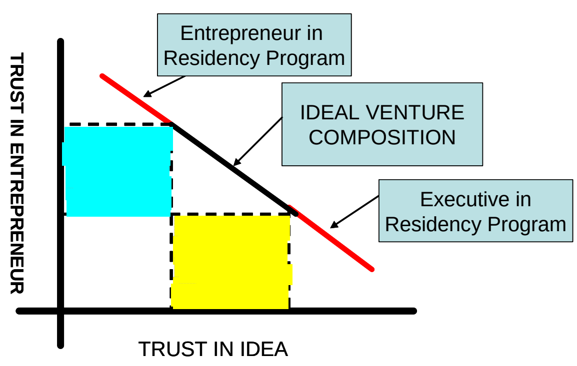

Figure 1. EIR and trust (entrepreneur or idea)

The Equity Gap

A startup/seed information and communication (ICT) venture usually consists only of an idea (vision) and a management/ entrepreneurial team; typically it has no income and faces uncertain market conditions (customers and competitors are unclear). Seeking and obtaining external financing at this startup/seed stage may be extremely difficult (Wetzel, 1983).

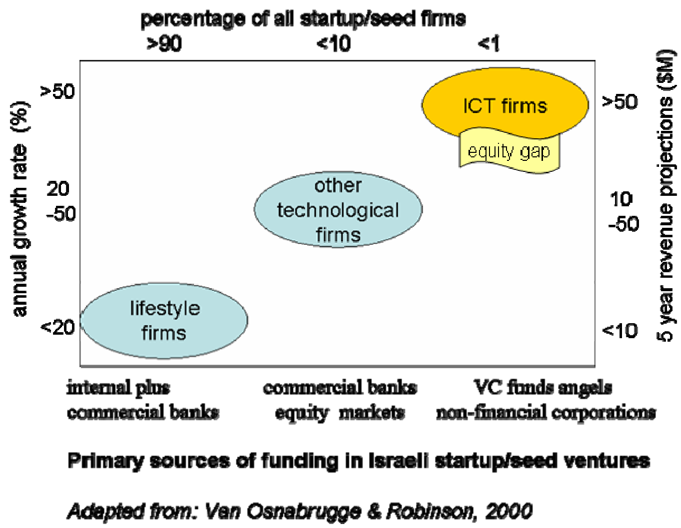

Figure 2. Primary sources of funding in Israeli startup/seed ventures

This is particularly due to the *equity gap* that exists for ICT firms (Figure 2) (Wetzel, 1986; Wetzel & Freear, 1994; Mason & Harrison, 1996). This equity gap is best defined as "the small amounts of risk capital from institutional sources for ventures at the startup/seed stage which arise because of the fixed costs of investment appraisal and monitoring that make it uneconomic for venture capital funds to make small investments and also because of the reluctance of banks to make unsecured lending" (Mason, 1996).

Although the presence of equity gap is clear, its cause is ambiguous. Traditionally, the gap has been attributed to a shortage of risk capital in the marketplace (Freear & Wetzel, 1991; Duxbury, Haines and Ridding, 1996; Wetzel, 1983). The explanation has been modified and now the gap also is attributed to fragmentation of the marketplace, where financial markets cannot freely provide all relevant information about fund sources, investment opportunities and financial control to the buyers and sellers of risk capital for startup/seed stage ventures (Wetzel, 1983; Wetzel and Wilson, 1985). ICT startup/seed ventures have always been characterized by very high levels of information asymmetries between the entrepreneur (who is selling a piece of his vision) and the venture capitalist (who is buying equity in someone else's dream).

Two schools of thought have been used to explain the equity gap for ICT startup/seed stage ventures, one concentrating on the demand side and the other on the supply side. The demand side explanation relies on the claims of the suppliers of financing that investment proposals (entrepreneurs and their visions) are often low in quality (Van Osnabrugge & Robinson, 2000). The supply side explanation suggests that the preferences and lending practices of institutional equity investors restrict investment regardless of the level of available funds (Mason & Harrison, 1992). These restrictive practices are due to the small size of the desired investment and to the fact that the transaction (costs during due diligence stages) and monitoring costs (costs of managing their investment during the initial startup/seed stage) alone, without considering the risk factors, may make it unfeasible for venture firms to offer funding (Alvarez, et. al., 1997; Mason and Harrison, 1992).

Even though the potential for higher returns is generally recognized, no more than a low percentage (Table 1) of venture capital fund portfolios focus primarily on such investments, mostly because successfully managing the risks of startup/seed investments demands more from the investment team than the traditional monitoring approach used for later stage investments (Roberts & Tempest, 1998).

The perceived costs forecasted by the VC partner, while calculating the return on investment for a decision to invest in a venture, result from certain links between different types of trust, control and risk (Giudici and Paleari, 2000; Shepherd, D. 1999, Cope, Cave and Eccles, 2004).

Only by understanding these relationships can we explain the equity gap phenomenon. In our equity gap framework, *EIR programs are the variable that connects trust, control and risk.*

Risk

Perceived risk is different from uncertainty, because risk perception usually relates to the estimated probabilities of several negative outcomes. In the literature, this focus on the negative outcomes of risk taking has been generally acknowledged to be the most relevant (March and Shapira, 1987). In making decisions about whether to invest in a venture, VCs consider two types of risk: relational risk and performance risk.

Relational risk relates to the consequences of not having satisfactory cooperation or opportunistic behavior by the entrepreneur (Das and Teng, 1996). Performance risk relates to the probability and consequences that the venture objectives will not be achieved, either due to a performance failure by the entrepreneurial team or due to poor understanding of the ICT market. (Das and Teng, 1996).

Trust

This paper will use the term *trust* (the subjective state of having positive expectations) interchangeably with that of *trusting* (the behavioral consequences of trust).

Trust is an essential aspect of healthy human relationships (Handy, 1999). Trust and trusting relationships are important aspects of building business alliances and, at an even more basic level, they are essential to the well being of individuals (Flores and Solomon, 1998). Humans are more likely to engage in dialog, share information and build ventures with people whom they trust (Flores and Solomon, 1998).

The health of a business venture depends on the trusting relationships of its agents. Trust promotes network relations (Miles and Snow, 1992) and reduces harmful conflict and transaction costs (Meyerson, Weick and Kramer, 1996). Ventures with a high level of trust foster a sense of community in which everyone takes responsibility for the venture and its well being (Gibb, 1991). Trust entails a positive expectation about the entrepreneur, suggesting that unpleasant outcomes are less likely (Lane and Bachman, 1996).

Trust (both trusting others and being trustworthy) is related to the character of individuals and their relationships (Flores and Solomon, 1998). Trust is not one dimensional, but changes character in an iterative process as a relationship develops and individuals' knowledge of the other person grows (Lewicki & Bunker 1995, 1996): "Calculus-based trust," which exists in the early stages of a relationship is the economic calculation of the value of maintaining the relationship relative to the costs of severing it. "Knowledge-based trust" exists between two individuals who have a history with each other and know each other well enough to make predictions about the other. "Identification-based trust" exists because the parties effectively understand and appreciate the other's wants to the extent that each can effectively act for the other.

Risk must be incorporated in the definition of trust because trust is only relevant in risky situations. Without uncertainty of outcome, trust has no role of any consequence (Boon and Holmes, 1991; Coleman, 1990; Deutsch, 1958). In other words, trust represents the positive expectations regarding the other in a risky situation (Boon and Holmes, 1991; Gambetta, 1988) and the behavioral reliance on the other in a risky situation (Hosmer, 1995; Moorman, et al 1992).

The greater the ability to rely on trust, the less the risk inherent in a transaction (Ring and Van de Ven, 1992; Madhok, 1995). An entrepreneur's trustworthiness reduces agency costs, protecting the VC (principal) against any harmful behavior by the entrepreneur (agent). However, trustworthiness delineates only the entrepreneur's *intentions* to do appropriate things, not his *ability* to accomplish them.

Trust in a VC-E (venture capital partner and the entrepreneur) relationship can take several forms. By becoming a member of the EIR program, in a first tier VC partnership, a high-status entrepreneur transfers legitimacy to the VC and vice versa (Fried & Hisrich, 1995). Competence-based trust is based on expectations of technically competent role performance (Barber, 1983), ability and expertise (Mayer, et al, 1995). An entrepreneur's competence suggests a high probability of accomplishment — but it concerns only the *ability* to do appropriate things, not the *intention* to do so.

An entrepreneur's competence influences venture funding by mitigating the liability of newness (Stinchcombe, 1965), conferring status and legitimacy (Blau & Duncan, 1967), affecting capabilities and skills (Becker, 1975), and shaping the resource networks of the entrepreneur (Burt, 1992; Granovetter, 1974).

Status/legitimacy is a highly valued entrepreneurial competency. Entrepreneurs who possess legitimacy can more easily obtain necessary resources than those who do not (Hannan & Freeman, 1989). High-status entrepreneurs will generate the necessary legitimacy to motivate potential investors, employees and other stakeholders to reallocate resources to the new venture. Their status gives the stakeholders more confidence in the proposed ideas and makes them more likely to attribute high value to those ideas (Shane & Khurana, 2001). In the case of an invention, evaluators will rely on the status of the inventor in making decisions about the opportunity (Merton, 1973).

Another entrepreneurial competency—the ability to identify opportunities—has been recognized as one of the most important abilities of successful entrepreneurs (Ardichvili, Cardozo & Ray, 2003). Opportunity identification may be related to, among other factors, entrepreneurial alertness (Kirzner, 1973), prior knowledge (Shane, 2000), social networks (Singh, Hills, Hybels, & Lumpkin, 1999), entrepreneurial cognition (Baron, 1998) and potential financial reward (Schumpeter, 1976).

Control

Control refers to the establishment and use of formal rules, procedures and policies to monitor and reward desirable performance. It is the process by which venture goals are set and the ways they will be measured and evaluated (work plan checked against measures and objectives as preset in the business plan) (Geringer and Hebert, 1989). Control also focuses on process, which turns appropriate behavior into a desirable output. It is the measurement of behavior itself, not merely the final output.

Control is a process of regulation and monitoring designed to make elements of a system more predictable (Leifer and Mills 1996) for the achievement of a certain goal, standard or purpose (Green and Welsh, 1988). More generally, control can be viewed as any process that is intended to affect the behavior of other people (Sohn, 1994).

Once an investment in a startup/seed venture is made, the investment is illiquid, and its success is highly dependent on a small group of managers/entrepreneurs in the venture (Fried & Hisrich, 1994). It is in the interests of both entrepreneurs and VC fund partners to do everything possible to ensure control that will allow them to collaborate effectively (Tyebjee and Bruno, 1984).

Control can take place across the whole spectrum of managerial activity, from strategic planning to operational matters. VCs can be vigorous and influential board members and play a significant part in shaping operating strategies (Rosenstein, 1988).

Mainly because of time constraints, VCs tend not to become over-involved in day-to-day operations unless control measures show that major problems have arisen; assistance most frequently includes help in raising additional funds, strategic planning and management recruitment (Gorman & Sahlman, 1989). Paradoxically, a more intense level of involvement by VCs does not necessarily mean that ventures will operate better than they would with limited involvement (MacMillan et al., 1989).

Determining an appropriate control mode depends on two factors: 1) an understanding of the transformation process in which appropriate behaviors are to take place and 2) the ability to measure outputs precisely and objectively. The VC has two needs for control: the need to control the entrepreneur and the need to control the venture.

This study recognizes the intricate relationship between trust and control**.** On one hand, control is detrimental to trust because regulation implies a sense of mistrust (Argyris, 1952). On the other hand, proper control mechanisms increase trust because "objective" rules and "clear" measures help to institute a track record for people who do their jobs well (Goold and Campbell, 1987; Sitkin, 1995).

Study Design

Research Question

Much has been written about how VC partners check entrepreneurial ventures before they invest (Cable and Shane, 1997; Hoffman and Blakely, 1987; Amit et. al., 1990; Bruton et. al, 1997; etc.) and how they forecast the new venture performance (Brush and Vanderwerf, 1992; Cooper et al, 1994, etc.). However, a review of the literature did not yield any studies concerning the ability of VCs to reduce the amount of risk they include in the forecast of future ROI, nor about influencing the performance itself at the pre-birth stage of ventures (startup/seed stage).

The idea for this research came from the knowledge that many repeat entrepreneurs were being hired as EIRs at the Israeli based VCs (local and locally based US VCs). In the absence of literature about the EIR process and its outcomes, we were motivated to ask:

How do participants in EIR programs perceive the value of the program?

How does the supplementary relationship between trust and control influence the VC decision to invest in a specific "deal?" Could we identify the specific dimensions of trust and control that influence the VC's "confidence coefficient," based on EIR program characteristics?

Our initial conceptual model is shown in Figure 3 below:

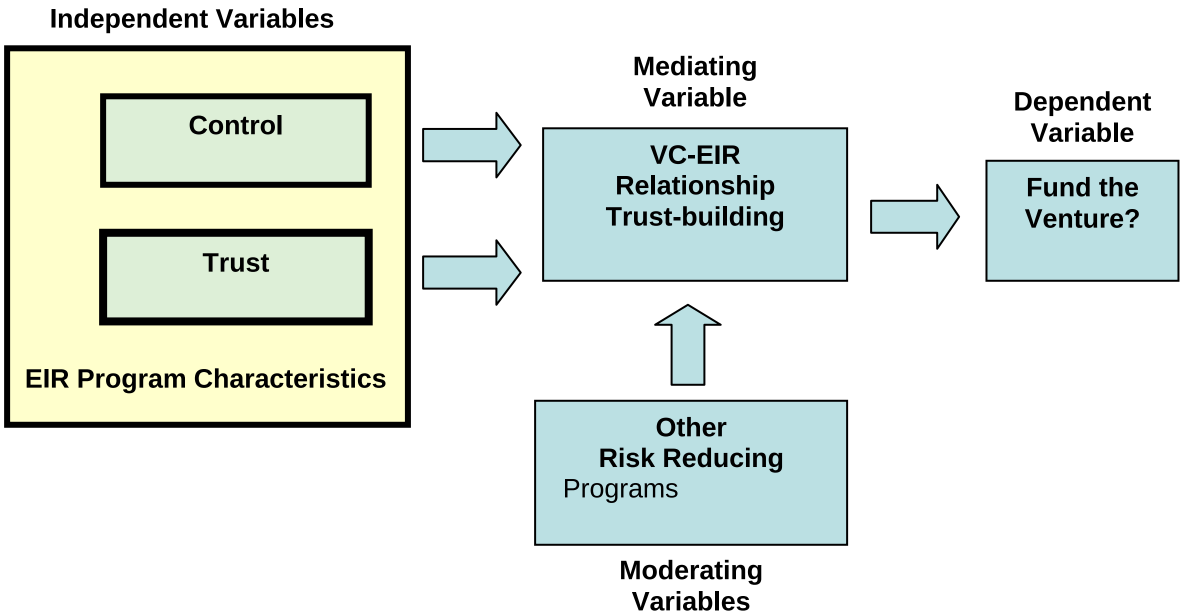

Figure 3. Preliminary conceptual model

We were interested in examining the characteristics of trust and control that operate in an EIR environment from the perspectives of the principals active in it – both VC partners and entrepreneurs. We positioned trust and control as independent variables in our model and sought to capture how individuals collaborating in an EIR perceived how they affect the venture funding decision. Specifically, we were interested in understanding how the relationship between the VC partner and EIR would mediate the influence of trust and control on funding. We also wanted to look at how government risk-reducing programs and investment syndicates moderated the VC-EIR relationship to affect the funding decision.

Research Method

The research involved a grounded qualitative approach based on semi-structured interviews (Strauss and Corbin, 1998). We chose this methodology because the intent of the study was to build theory about the barriers to and enablers of success in Israeli EIR programs and doing so required a deep understanding of the attitudes, beliefs and perceptions of individuals involved in them. Semi-structured interviews allowed us to generate general information about the dynamics of EIRs as well as to probe people's perceptions about how highly subjective factors, such as trust and controls, are perceived to operate within them. As new ideas emerged from our interviews, we returned to the literature, thereby iteratively enriching our understanding of the constructs in our original conceptual model and consequently revising the model to reflect the knowledge yielded by our data.

Sample

Selection of the subjects for the study was done through criterion-based selection (Maxwell, 1941). This is a strategy in which particular settings, persons, or activities are selected deliberately to provide information that cannot be obtained as well from other choices. The people chosen were able to describe EIR programs and their results because they were part of EIR programs, either as VC partners or entrepreneurs. We looked only for primary decision makers in the VC firms (CEO) and the entrepreneurs in EIR programs (different stages). We also interviewed three outside observers: a bi-national technology foundation vice president who funds early stage ventures (Table 2); an angel investor who was previously a successful repeat entrepreneur; and an entrepreneur who had started a venture without an EIR program.

We were interested only in VCs that invested in ICT startup/seed ventures. Of the 57 VCs in Israel in that category (out of sixty-two active VC partnerships), we interviewed the chief executives of ten firms. The total capital raised by all VCs in Israel from 2000-2004 was $5.6 billion; our sample included VCs that raised $2.3 billion (41 percent of the total).

The VC CEOs whom we interviewed represented the two different types of VC partnerships that participate in the Israeli scene: Five were from Israeli offices of Silicon Valley VCs and five were from local Israeli VCs. We also differentiated the sample on the basis of firm size. We included two "big" VCs (funds between $331M and $850M), three "medium" VCs (funds between $ 150M and $330M) and five "smaller" VCs (funds between $60M and $150M) (Table 3). Our "entrepreneurial" sample (Table 4) included two EIRs in the resident phase, two EIRs who had crossed the equity gap during the last year and an entrepreneur (non EIR) who had crossed the equity gap two years previously.

interviewee	local VC	size of fund in Israel	# of ventures at startup/seed stage (2000/4)
VC1	yes	small	16
VC2	no	small	13
VC3	no	medium	24
VC4	no	medium	20
VC5	yes	small	9
VC6	yes	small	9
VC7	yes	medium	18
VC8	no	big	32
VC9	no	big	40
VC10	yes	small	15

Source: IVC Research Center

Table 3. Data about the VC-CEOs interviewed

EIR1	1 year old venture
EIR2	now looking for idea
EIR3	just started the venture
EIR4	now looking for idea
E1	2 year old venture

Table 4. Entrepreneur data

interviewee	background is high status	high status because of?	previously an E
VC1	y	technology management	y
VC2	y	management	y
VC3	y	technology management	y
VC4	y	technology management	y
VC5	y	technology management	y
VC6	y	technology management	y
VC7	y	technology management	y
VC8	y	management	n
VC9	y	management	y
VC10	y	management	n
Foundation	y	management	n
Angel 1	y	technology management	y

Table 5. Investor background

interview	background is high status	high status because of?	repeat entrepreneur	VC investment needed by you should be mostly nonfinancial?	same background exists between VC and E
EIR1	y	management	y	y	y
EIR2	y	technology management	y	y	y
EIR3	y	technology management	y	y	y
EIR4	y	technology management	y	y	y
E1	y	technology management	y	y	n

Table 6. Entrepreneur background

All except one of our investor interviewees (Table 5) were male. All were in their fifties, lived in the central region of Israel, served in the Israel Defense Forces, were technologically savvy and had extensive managerial experience. Nine of the 12 were repeat entrepreneurs. The entrepreneurial interviewees (Table 6) had the same backgrounds as the investors except for all being in their thirties.

Interview Protocol

The data was collected through semi-structured interviews that lasted no more than 90 minutes each. The interviewing (in English) was done during July and August 2005 in the interviewees' offices, which were located mostly in the Dan Area of Israel (Israel's version of Silicon Valley). The interviews were taped and transcribed for analysis and anonymity of the participants was ensured. Most of the questions focused on EIR programs, startup/seed investment and respondent's respective experience in crossing the equity gap. The interviews were designed to elicit interviewees' perceptions of high-status individuals, venture and entrepreneurial performance, VC's non-financial investments, perceptions of the relationship between the parties (before, during and after the EIR programs), definitions and stages of trust and similarity of backgrounds (especially their experiences in the Israel Defense Forces and its influences) (see Appendix A).

Coding and Analysis

We coded the interviews in eight iterations. For the first two iterations, we used a spreadsheet and cataloged part of the answers. After the third iteration, we needed a tool for analyzing responses related to relationships; for this, we used Microsoft's OneNote 2003. This application allowed us to take apart, catalog and search for quotes in the interview transcripts (Appendix B).

The first iteration helped us to discover how the participants felt about the program: whether they would repeat it; if they would recommend it to another VC or entrepreneur; and if/how they believed it achieved expected results. For this part of the coding, we used simple Excel spreadsheets.

The second iteration yielded insights on EIR program definitions, VC-EIR relationships, VC-EIR background similarities, and other risk-reducing incentives (such as government incentives and syndicates).

The third iteration validated our early conjecture that the relationship between trust, trust building and future control costs was important. We realized at this point, however, that the mediating variable that influenced the VC CEOs to fund the venture was not the relationship between the VC and the EIR, but something we termed "confidence coefficient of the deal" (reflecting frequent use of that term by the VCs interviewed). The confidence coefficient is the VC's confidence in the entrepreneur's intention and ability to deliver the deal's return on investment. This motivated us to revise the conceptual model before continuing the coding so as to reflect this change in mediating variables (from the relationship between the EIR and the VC to the VC deal confidence coefficient) (Figure 5).

When, in our fourth iteration, we coded for the confidence coefficient, we discovered that it was inversely related to the perceived risk in the forecasted venture valuation gains.

The fifth iteration coded for perceptions and determinants of failure (failure of repeat entrepreneurs and failure of ventures).

In the sixth iteration, we coded for different types of perceived costs and their relationships with control, trust building and trust. Here we discovered that our respondents distinguished between different types of risk, trust and control. This caused us to return to the literature to review research involving these constructs.

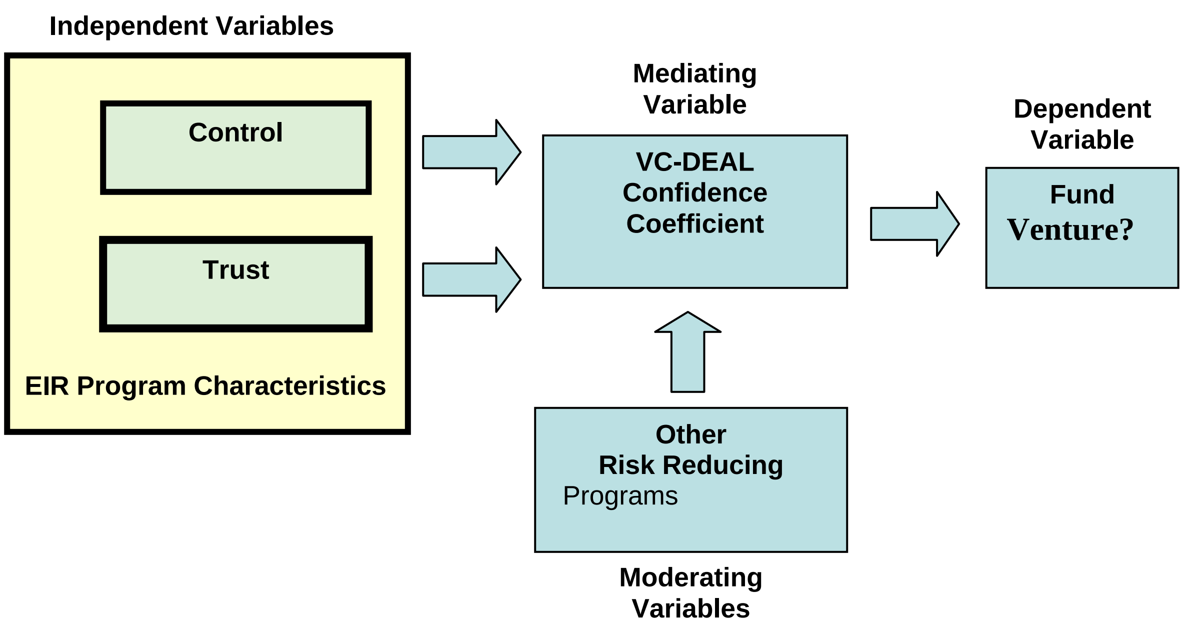

Figure 5. New model

For the next two iterations, we borrowed from the literature an existing framework providing definitions of risk, control and trust for strategic alliances (Das and Teng, 2001). The use of this framework helped us to discover and define the trust and control types that play a part in the EIR program and how they affect the confidence coefficient of the VC CEOs. We used the framework to code for two trust constructs (goodwill trust and competence trust) and three control constructs (behavior, output and social controls).

Our coding resulted in a revision of our original conceptual model as described and discussed in the next two sections.

Findings

Our data confirmed the general assumption underpinning the original conceptual model: that trust and control are critical factors driving EIR success. We learned, however, that the role trust and control play in the EIR process is far more intricate than we had conjectured. Our respondents revealed, for example, that they distinguish between two types of trust and three types of control. Borrowing from the work by Das and Teng (2001) we refer to those as competence trust, goodwill trust, behavior control, output control and social control.

Trust

Our findings indicate that two contrasting types of trust operate in the EIR context: competence-based trust and goodwill trust. The first is the ability to accomplish (see Figure 6) while the second is the intention to accomplish (see Figure 7).

Competence Trust. Our respondents reported that trust in the competence of entrepreneurs who participate in residency programs was crucial to them. Competence trust was developed in the EIR-VC relationship in two ways: through research and demonstration. VCs reported that they actively research the competence and trustworthiness of entrepreneurs by using personal and professional networks to obtain information about the entrepreneur's past relationships with investors. In addition, they purposely expose entrepreneurs to a variety of VC activities that require demonstration of their competencies and skills.

Respondents reported that their network-based research on entrepreneurs was focused in large part on identifying the "status" of these individuals which was perceived as evidence of or contributing to competence. Attributes characteristic of preferred "high" status individuals included 1) previous venture founding experience (although not necessarily successful) demonstrating the skill and fortitude necessary to create and manage an organization; 2) service as an officer in a prestigious combat unit (fighter pilot, commando and other elite forces) demonstrating leadership and teamwork skills; 3) experience in the market as a customer (in the IDF computer units) or supplier (in software development), possessing information not publicly available about the ICT technology.

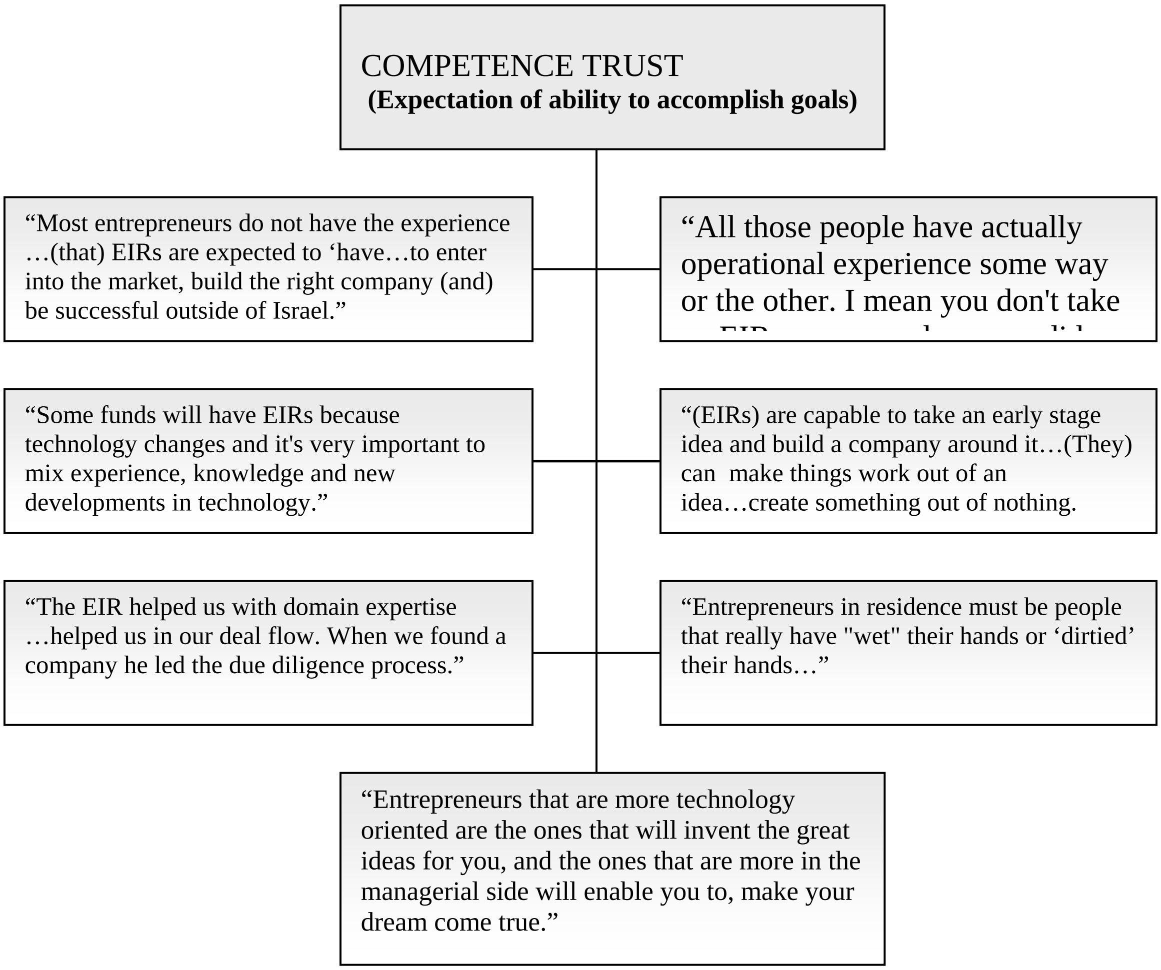

Figure 6. Competence trust

Goodwill Trust. Our respondents distinguished a second type of trust that we have labeled "goodwill" trust, which they reported may be influenced by cultural factors or be developed through institutional efforts. Homogeneity of social and professional background and status, similar values/norms and preexisting mutual interests, for example, were reported to engender trust and reduce conflict among EIR participants. In addition, VC created programs such as internships and purposefully constructed "incremental step" processes were seen to foster goodwill and increase commitment among EIR participants.

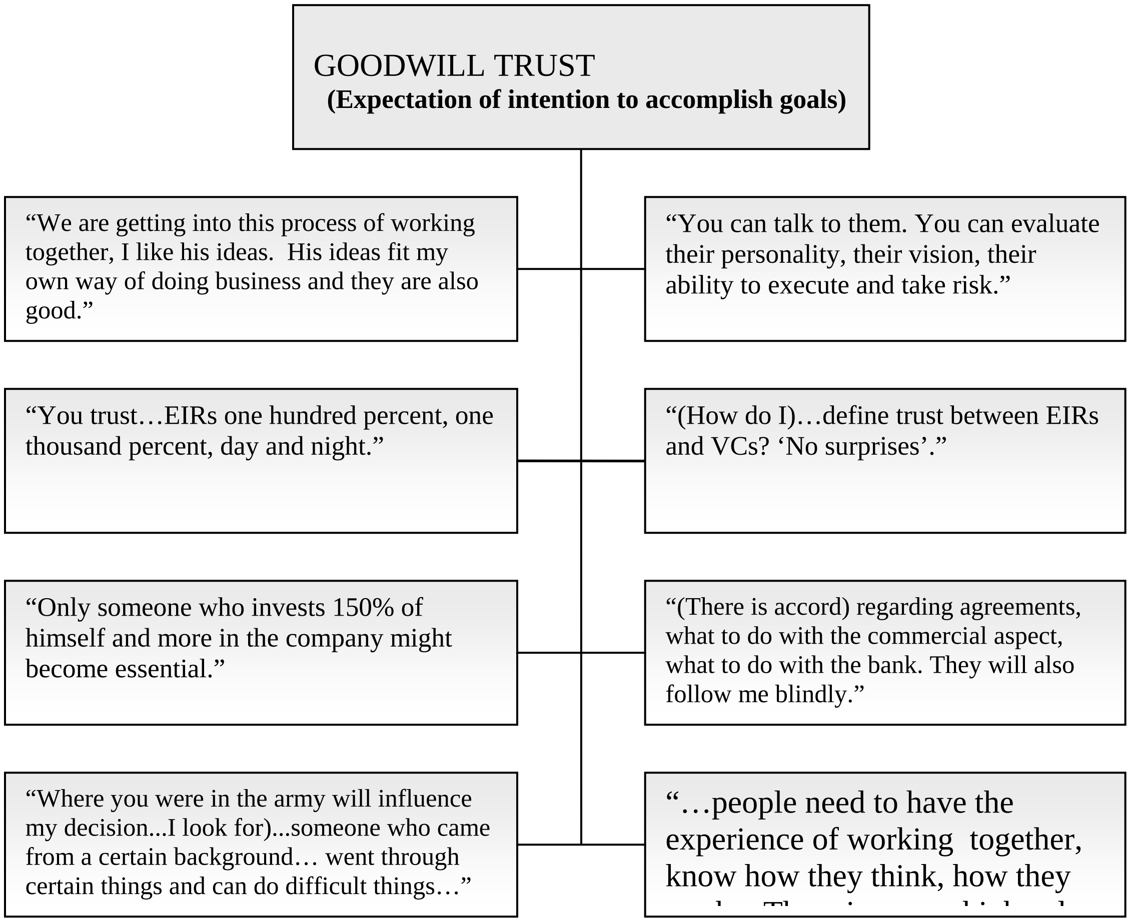

Figure 7. Goodwill trust

Control

Our findings indicate that VC principals consider control to be a very important criterion in ensuring a new venture's success. In discussing control, our participants differentiated between three distinct types that resemble those widely accepted in the literature: behavior, output and social control (Eisenhardt, 1985). For clarity, therefore, we have used these established labels to report them.

Behavior Control. Our respondents reported that they used policies and procedures to clarify the roles and responsibilities of entrepreneurs participating in EIR programs and to supervise, monitor and assess compliance. All of the VC executives we interviewed reported making both formal and informal efforts (though mostly informal) to ensure behavioral compliance of participants in their EIR programs. These included training in VC ROI goals, deal flow investment rules, venture validation methodology, business plan rules and working with boards.

VCs were careful to point out that, while they believed behavior controls were necessary, they were best implemented somewhat informally. Although entrepreneurs are mature, high status, quite experienced and highly successful individuals, their entrepreneurial personalities preclude the imposition of rigid rules and regulations.

All EIRs were strategically (yet informally) exposed to all VC personnel, new project proposals, existing investments and other entrepreneurs in the investment portfolio. The reported purpose was to indoctrinate entrepreneurs about “the way things are done here.” The VC interviewees emphasized that, while the EIR program had no strings attached and after the one year there would be no obligation, it was important that while the program was ongoing, entrepreneurs in residence should “fit in” to the firm.

While making proactive efforts to facilitate this fitting in, the VCs ensured that entrepreneurs also were responsible for getting “out and around” the firm independently, lobbying for meetings and getting on agendas, brainstorming with partners, etc.

Our data showed that the EIRs understood and appreciated the importance of the behavior mechanisms used by the VCs. Although all our EIR respondents had been repeat entrepreneurs, they reported that the experience of being inside the VC — where they could more easily understand its mechanisms and goals — was extremely helpful in later due diligence and board dealings.

The EIRs also acknowledged feeling “mentored” by-one or more of the VC partners (usually individuals with similar technology domain experience). They believed that their mentors had taken the internship very seriously, investing ample time in meetings and brainstorming sessions with them.

Our respondents also noted that specific VC “behavior” control continues once a venture gets funded – and then becomes increasingly formal. At that point, all VCs reported that strict policies and procedures, incorporated as part of all investment contracts, specified acceptable boundaries of behavior (and the rewards associated with rule compliance). They also revealed the presence of strict reporting structures providing role specification for everyone in the venture and explained their beliefs that such purposeful articulation about roles facilitate~~s~~ the process of supervision and monitoring.

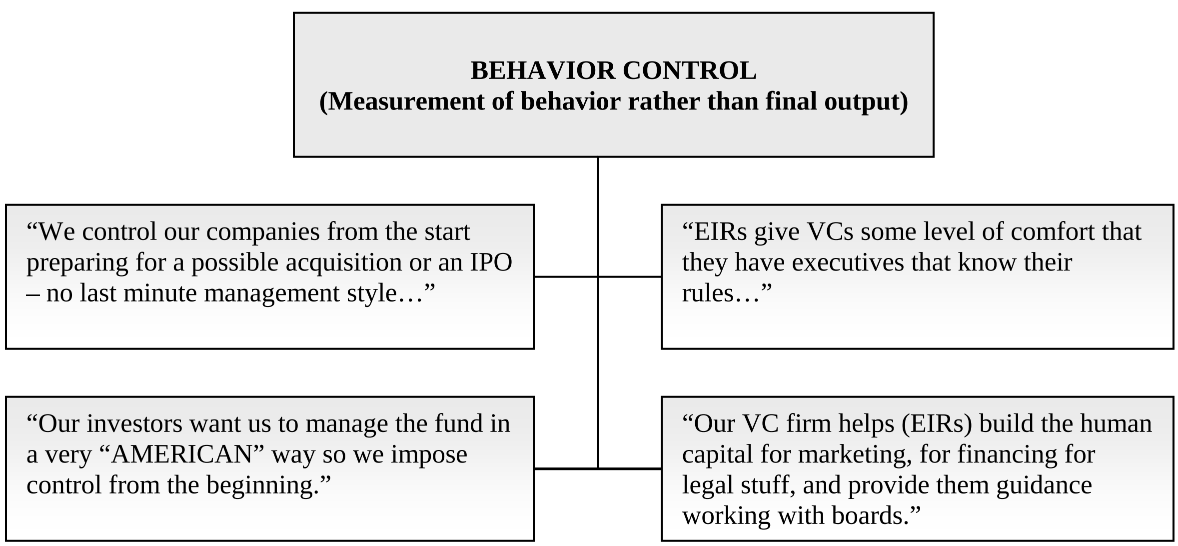

Figure 8. Behavior control

Output Control. Our respondents defined the EIR internship as a first step in getting the entrepreneurs into the VCs’ constant evaluation and measurement routine against proposed plans and forecasted expenses. All VC CEOs described establishing objectives and performance measures to measure/evaluate EIR output and allow the VC to exercise control over performance. The VC CEOs also confirmed that they expected from their entrepreneurs detailed reports of work plans, business plans, budgets, etc. After they invest in the venture, our VC respondents understand that equity stake does not automatically give them the right/ability to set their own output measures as the norm; this is a subject open while negotiating investment syndicates.

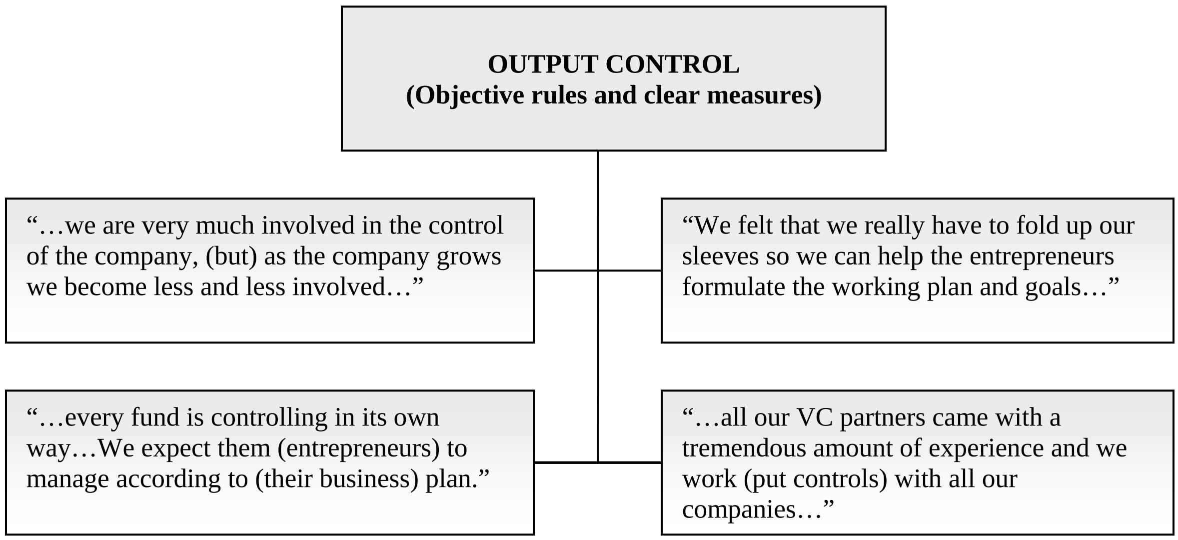

Figure 9. Output control

Social Control. Our data documents that a third type of control called "social control," which is widely described in the literature as being typical in the operation of strategic alliances, was also present in the EIR context.

We learned that, unlike internship programs where novices are under the strict tutelage of supervisors, EIR programs attract young, experienced and successful repeat entrepreneurs who would chafe under rigid governance and whose creativity and drive would be compromised by it.

Participants in EIR programs are closer to peers than fledglings. For this reason VCs report that social controls, while important, must operate very delicately. We found that social control operated informally to generate the kind of collegial work environment necessary to facilitate collaboration between VCs and entrepreneurs.

Our respondents understood the unique relationship between entrepreneur and VC. One needs the other to exist. In this relationship, the entrepreneurs are not the risk bearers; their function is to innovate. Risk bearing is the function of the venture capitalist that lends money to the entrepreneurs (Schumpeter, 1934; Acs et. al. 2005).

The VCs said they believed that optimal outcomes were most likely if the goals of entrepreneurs were synonymous with those of the VCs and reported that conflict of interest between the VC and the entrepreneurial team was a prime cause of venture failure. Although the VCs reported efforts to promote goal congruence, they clarified that the goals were entirely defined by the VC who, in an effort to encourage EIRs to conform to the goals, tried to create an atmosphere conducive to sharing them.

Respondents reported that, to make certain that entrepreneurs understood the goals of VC management and investors, they devised activities in which entrepreneurs could contribute to and discuss the goals. An example is due diligence negotiations with other entrepreneurs as part of the VC team.

VCs told us how they and the EIRs agree to the investment vision and returns through a decision-making process that ensures that VC preferences are understood and integrated into mutually acceptable goals and plans. As a result, many of our respondents – both VCs and entrepreneurs – described the EIR internship culture using terms such as “communicative,” “collegial,” and “consultative.” All respondents displayed an understanding of the importance of a positive, supportive and interactive work environment that fostered trust, confidence and interdependence.

All parties in the program reported as critical the importance of honest and open communication. To this end, VCs reported instituting mechanisms to encourage and facilitate information exchange. These ranged from staging cross-functional meetings and other activities to promoting social interaction between entrepreneurs and others in the VC and introducing organizational ideas that could be translated into behavioral models to guide decisions about their ventures.

The VCs also made sure that communication with entrepreneurs would be efficient and expedient. Mentor VCs and EIRs reported receiving from each other six or eight e-mails per day about certain subjects. VCs also reported that they opened their networks, both personal and professional, to entrepreneurs.

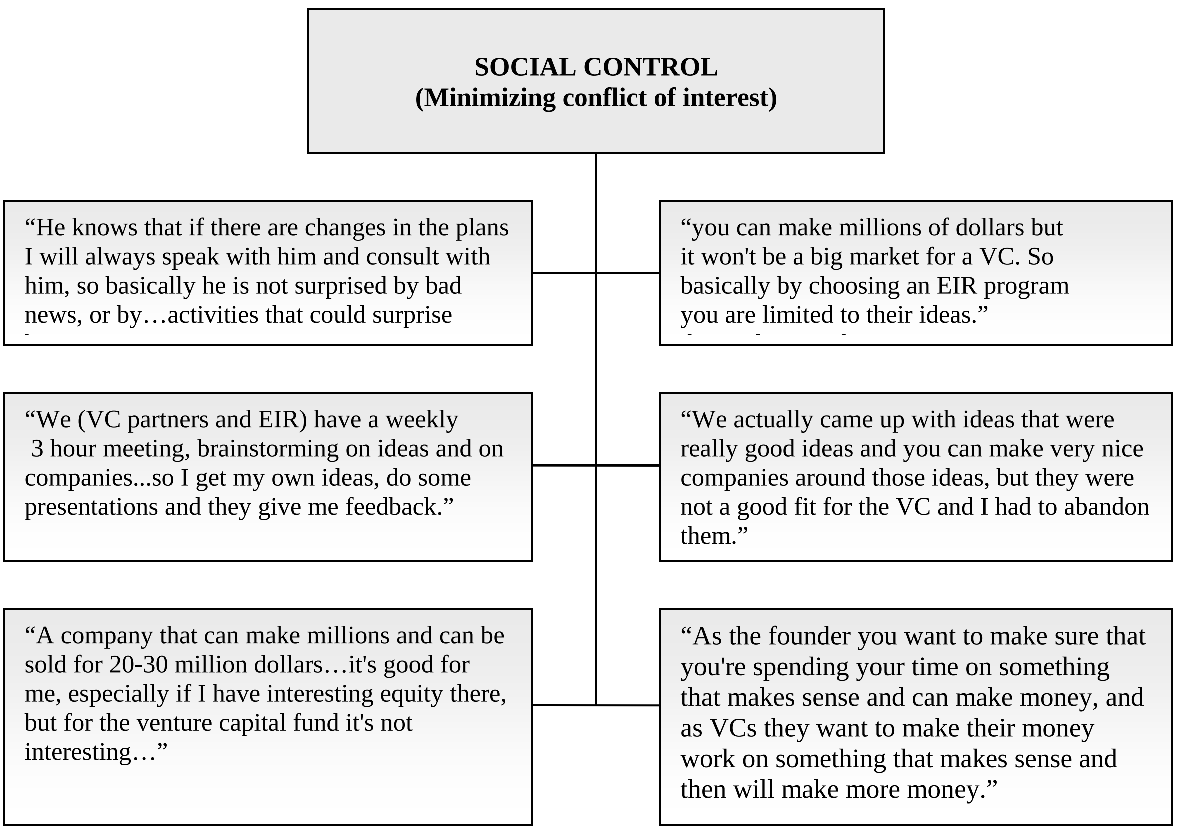

Figure 10. Social control

Our interviews also revealed a consensus between all CEOs of the VCs as to the main reasons for failures of young non-EIR ventures and the remedies for such failures as described by trust and control. According to our respondents failures in the first phase of the life of an ICT startup/seed venture in Israel are attributed to:

1. Entrepreneurial team in-fighting and eventual inability to execute. This was reported to occur because not enough effort was made by the VCs (during due diligence) to make sure the team was of similar backgrounds and/or had mutual interests. It is quite common for VCs today to change parts of the team as a condition for investment. Our VC respondents believed that common backgrounds helped to ensure more goodwill trust among team members and that social control helped to fortify shared norms and values that increased that trust.
2. Poor international marketing and sales. Our respondents noted that VCs now look for repeat entrepreneurs that have this type of experience even if the first time around it was not very successful. By including sales/marketing prowess as part of what constitutes competence trust, VCs reduce risk of failure.
3. Inability of entrepreneur to let go and start anew. VCs reported that the most important thing they look for in an entrepreneur is the ability to understand and trust product changes dictated by the board. Goal congruence, fortified by social control, is seen by VCs to fuel the goodwill trust that motivates EIRs to accept VC decisions.
4. Conflict of interest between the VC and entrepreneurial team. This reported source of failure, the VCs indicated, is also remedied by strong goodwill trust.

The VC CEOs interviewed explained to us that VC partners use two sources of funds: deal-flow investment monies and the VC's management fee (usually 2 percent per year). The transaction costs associated with forming and financing new ventures and the monitoring costs borne by the VC firm come out of the management fee. Although costs of making new equity investments in startup/seed ventures have been decreasing, they still can account for as much as 10 percent to 15 percent of the initial investment. All VCs interviewed talked about using government incentives and VC syndicates to reduce these costs (Table 7).

interviewee	have EIRs	% of EIRs that finally got investment ?	does your VC offer managerial BPO for E during first year?	uses syndication to lower risk	uses/used government incentives	VC investment should be mostly nonfinancial?
VC1	3	100.00%	y	y	y	y
VC2	1	100.00%	y	y	n	y
VC3	5	40.00%	n	y	n	y
VC4	0	0.00%	n	y	n	y
VC5	0	0.00%	y	y	y	y
VC6	0	0.00%	y	y	y	y
VC7	8	50.00%	y	y	y	y
VC8	2	50.00%	y	y	y	y
VC9	10	80.00%	y	y	y	y
VC10	4	50.00%	y	y	y	y
Foundation	0	nr	n	y	y	y
Angel 1	3	100.00%	y	y	n	y

Table 7. VC control and other risk reducing tools

Transaction costs include entrepreneurial evaluation, technological evaluation, due diligence and, finally, the signing of a contract. Our interviewees mentioned that, because startup/seed companies have no performance history, they are difficult to evaluate. The most important factor that influences perceived transaction costs, all VCs told us, is the need to forecast team behavior.

Monitoring costs include the time spent by employees of the VC firm in establishing and later controlling activities in the new venture. Some of our VCs offered BPO (business process outsourcing of financial, H/R and other functions) services (Table 7) to the young firms at the beginning, because it was cheaper than controlling them. With time and venture sophistication, these functions were transferred to the venture.

All interviewees told us that EIR programs are financed through the deal flow monies. When the EIR joins the VC, a formal company is formed with the entrepreneur as its sole owner. The monies are invested through a convertible loan. If the VC decides to invest the loan, it is discounted at a predetermined rate. If the entrepreneur takes the venture to be funded somewhere else, the loan has to be repaid. It is like buying an option to invest. The decision to start the process of due diligence is based on the forecasted future valuation increase (based on the technological validation) and the forecasted transaction/monitoring costs (based on the entrepreneurial team behavior).

All investors agreed about the need for -- and high cost of -- VC partners' involvement in controlling the young ventures, and that this cost was reduced by EIR involvement prior to the investment.

Finally, our data suggest that VCs and EIRs perceived the program to be highly valuable for both sides. (Appendix B, Figure 11 and Tables 7 and 8). Of the 10 VC CEOs interviewed, all except one voiced the intention to continue EIR programs. Our sample VCs employed 36 EIRs at all stages of the program and a total of 204 startup/seed ventures in their portfolio.

Our findings about the roles of trust and control in EIR programs in Israel motivated us to amend our original conceptual model to more precisely explain VC decisions to invest in EIR deals (Figure 12). The sole independent variables in our original model were trust and control; in our refined model, independent variables include perceived transaction and monitoring costs and, antecedent to them, the two types of trust and three types of control that our sample revealed as operating in EIR programs. Perceived transaction and monitoring costs are seen to influence the "confidence coefficient" that, in turn, drives VCs' decision to fund an EIR initiated venture. The overall findings are summarized in Table 9 and the revised model is shown in Figure 12.

interviewee	local VC	size of fund in Israel	# of ventures at startup/seed stage (2000/4)	thinks EIR good idea	have EIRs	will start EIR in 2006?	% of EIRs that finally got investment ?
VC1	yes	small	16	y	3	y	100.00%
VC2	no	small	13	y	1	y	100.00%
VC3	no	medium	24	y	5	y	40.00%
VC4	no	medium	20	y	0	y	0.00%
VC5	yes	small	9	n	0	n	0.00%
VC6	yes	small	9	n	0	y	0.00%
VC7	yes	medium	18	y	8	y	50.00%
VC8	no	big	32	y	2	y	50.00%
VC9	no	big	40	y	10	y	80.00%
VC10	yes	small	15	y	4	y	50.00%
Foundation	no	nr	0	y	0	nr	nr
Angel 1	yes	nr	8	y	3	y	100.00%
totals			204		36		

Table 8. EIR programs at the VC sample

ENTREPRENEUR PERCEPTIONS of EIR Advantages

"When you are outside of a VC and you think of an idea it's difficult…You have to use your own connections…But here, when you are coming from within…it's quite easy to get you any meeting you want, and it's like you are doing it…in a luxury environment, and that's really good."

"When my friends...had (an) idea, they started courting the venture capital firms, go(ing) from one to the other and it's not an easy process, especially when you are not known. Now that I am inside I know that it's true."

"(The VCs) also helped me with validation… they helped me with their connections and it was very useful, very helpful."

"A VC firm will help in the human infrastructure, bringing chairmen with domain expertise or other key personnel to help in introductions to potential customers."

Figure 11. Entrepreneur perceptions of being part of the EIR program

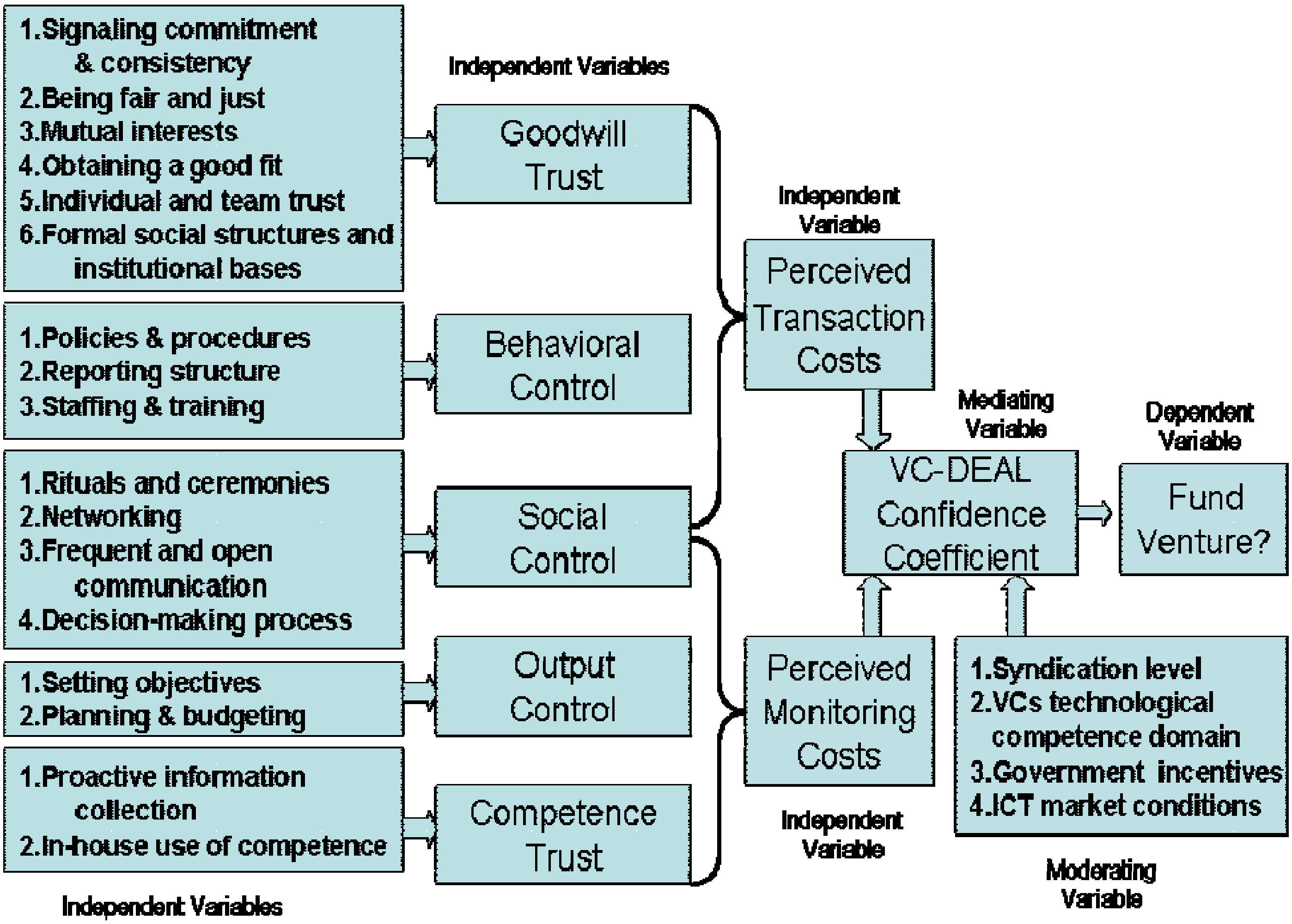

Figure 12. EIR framework

<table>
<tr><td>Trust and control are critical factors driving EIR success.</td></tr>
<tr><td>Two contrasting types of trust operate in the EIR context:
1) Competence-based trust (the ability to accomplish) which comprises
A) previous venture founding experience demonstrating the skill and fortitude necessary to create and manage an organization;
B) service as an officer in a prestigious combat unit demonstrating leadership and teamwork skills; and
C) experience in the market as a customer or supplier, possessing information not publicly available about the ICT technology.
2) Goodwill trust (the intention to accomplish) which is
• influenced by cultural factors such as
o homogeneity of social and professional background and status
o similar values/norms and preexisting mutual interests
• developed by institutional efforts such as
o VC-created programs such as internships
o "incremental step" processes</td></tr>
<tr><td>Three types of control operate in the EIR context:
1) Behavior control
• policies and procedures designed to clarify roles and responsibilities of entrepreneurs participating in EIR programs
• supervision, monitoring and assessment for compliance purposes
• training (formal and informal) in topics such as:
o VC ROI goals
o deal flow investment rules
o venture validation methodology
o business plan rules
o working with boards
2) Output control (optimizing performance)
• objectives and performance metrics designed to measure and evaluate EIR output
• detailed reports (work plans, business plans, budgets, etc) designed to give the VC control over the EIR's performance
3) Social control (minimizing conflict of interest)
• create a collegial, consultative culture (with EIRs and VCs on the level of peers)
• promote goal congruence
• encourage frequent and transparent communications</td></tr>
<tr><td>There is a need for -- and high cost of -- VC partners' involvement in controlling young ventures. This cost is reduced by EIR involvement prior to the investment.</td></tr>
<tr><td>VCs appear to use EIR programs to reduce the risks — the perceived transaction and monitoring costs — and overcome the equity gap obstacle.</td></tr>
<tr><td>If the VC is to invest in a startup/seed ICT venture, he must perceive a positive confidence coefficient on the future success of the venture. The confidence coefficient is based on the perceived transaction costs (forecasted costs of the due diligence process) and the perceived monitoring costs (forecasted costs for monitoring the venture during the first stage of its life).</td></tr>
<tr><td>Factors contributing to the confidence coefficient include:
1) Transaction costs
• entrepreneurial evaluation (most importantly team behavior)
• technological evaluation
• due diligence
• the signing of a contract
2) Monitoring costs — the time spent by employees of the VC firm in establishing and later controlling activities in the new venture.</td></tr>
</table>

Table 9. Summary of findings

Discussion

The relationship between a VC and an entrepreneur is more important to the success of a new venture than the capital itself (Greenwood, 1995; Sapienza and Korsgaard, 1996; Cable and Shane, 1997; Timmons and Bygrave, 1986; Shepherd and Zacharis, 2001) (Appendix B.5).

VCs and EIRs form a relationship based on information. Both cultivate knowledge about one another by gathering data, seeing each other in different contexts and experiencing each other's previous knowledge. In EIR programs, entrepreneurs co-locate into VC offices, create a joint vision for the venture, and share goals and core values relative to it. Eventually, if the principals decide to create the venture, they will be able to know and predict one another's (shared) needs and preferences (Appendix B.9). In successful programs, the EIRs will think, feel and respond like the partners of "their" home VC fund.

Our findings help us to understand the connections between the constructs of trust and control operating in an EIR program and the "perceived" future costs (of two types) that VCs calculate before they decide to enter into validation, due-diligence and investment. The value of these forecasted costs may influence the decision of a VC to invest (overcoming the equity gap) in a startup/seed company with no performance history.

Perceived future transaction costs of appraising and validating (due diligence) is mostly about entrepreneur-VC opportunistic behaviors. The perceived transaction cost may be influenced by the perception of goodwill trust by a VC of an EIR and affected by behavior control and social control mechanisms exercised by a VC. The VC (who is diversified among a number of portfolio companies) is in a different position than the entrepreneur (who typically has his/her financial returns dependent upon the success of this single venture) (Appendix B- section 8).

Perceived future monitoring costs (through the first stage of the venture) relates to forecasting the costs of controlling for results. In addition to considering whether the venture achieves its performance targets, VCs also consider the perceived outcome of the entrepreneur's activities. The perceived future monitoring cost may be influenced by perceptions of competence trust in an EIR by a VC, as well as by social and output control mechanisms used by a VC. In addition to providing risk capital in exchange for partial ownership of the venture, Israeli VCs typically actively involve themselves in the venture (Appendix B.2). Israeli VCs seek to add value through their interaction with and advice for the managers of the entrepreneurial venture (Macmillian, Kulow & Khoylian, 1989; Bygrave & Timmons, 1992), as well as through their monitoring and reorganizing of the companies in which they participate (Sapienza & Gupta, 1994) (Appendix B.6; B.9)

Our findings suggest that EIR programs allow a VC to manipulate and reduce the perceived transaction costs of appraising and validating (due diligence) the viability of the vision (idea) and the perceived monitoring costs (through the first stage of a venture).

VCs appear to use EIR programs to reduce the perceived forecasted transaction and the perceived forecasted monitoring costs in such a way that they reach a tipping point where the VCs will invest in a startup/seed stage venture and overcome the equity gap obstacle.

If the VC is to invest in a startup/seed ICT venture, he must perceive a positive confidence coefficient on the future success of the venture. This confidence coefficient is based on the perceived transaction costs (forecasted costs of the due diligence process) and the perceived monitoring costs (forecasted costs for monitoring the venture during the first stage of its life). Both of these costs directly influence the working relationship between the VC and the entrepreneur (EIR in certain cases). A positive "confidence coefficient" will indicate to the VC that a "deal" has low perceived transaction and perceived monitoring costs.

Other factors that influence the confidence coefficient are the state of the ICT-specific market conditions, the ability to reduce monitoring costs by including other VCs in a syndicate, by using government risk-reducing incentives and by investing only in fields where the VC has good technological domain expertise.

We portray our conception of a VC's forecasted investing behavior in Figure 7 below. The top quadrants forecast where the VCs will choose to invest given a particular knowledge domain (early stage ventures, mezzanine stage ventures and later stage ventures). For VCs to overcome the equity gap and invest in the lower left quadrant, they need programs like the EIR. This program facilitates VC investment in a venture despite low output measurability.

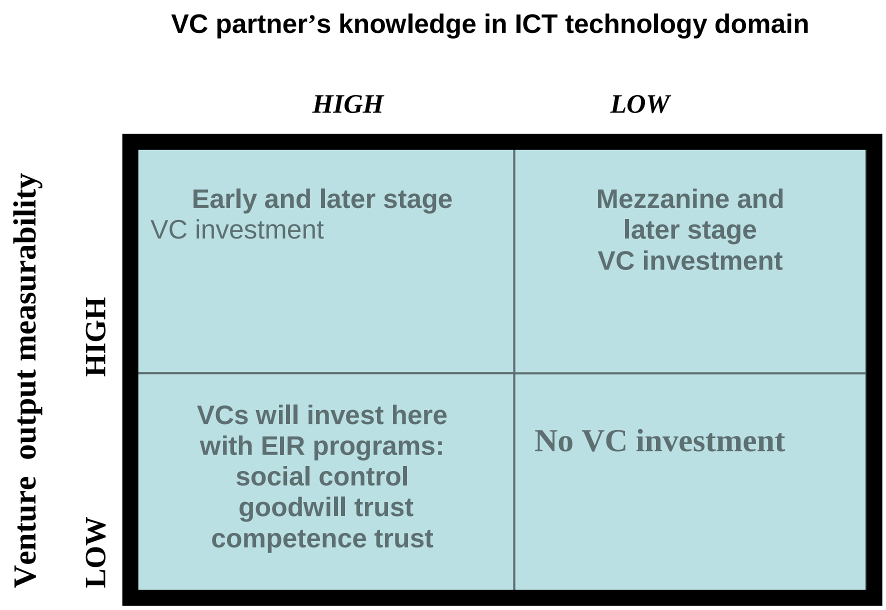

Figure 13. Measurability versus knowledge

VC evaluation of deals occurs only after pre-screening through recommendations, invitations to join syndicates, networking, etc. Only 5 percent to 10 percent of pre-screened deals are invited for evaluation.

In normal deal selection, the rule of thumb statistics (Appendix B) suggest that VCs invest in one out of every 350 deals that they evaluate (0.03 percent success rate). Through the EIR programs, those statistics (for evaluated and then invested ventures) have been changed to one out of two or three – a 30 percent to 40 percent success rate. This improvement of over 1,000 times constitutes a great cost reduction in the screening and evaluation process costs for the VCs in their search for startup/seed investments.

Based on a consensus of VC CEOs in our sample as to the reasons for young non-EIR venture failure, we suggest that perceived transaction and monitoring costs of startup deals may be reduced by EIR programs in which goodwill trust and competence trust are high and social control operates effectively.

		Behavior Control	Output Control	Social Control
Goodwill Trust	Transaction Costs	low	moderate	low
	Monitoring Costs	high	moderate	moderate
Competence Trust	Transaction Costs	moderate	high	moderate
	Monitoring Costs	moderate	low	low

Adapted from Das & Teng, 2001

Figure 14. Minimizing transaction and monitoring costs

Implications and Contribution

The main contribution of this research is that it addresses a new phenomenon about which not much empirical knowledge has been previously generated:

> "There is a fundamental market failure in the provision of early-stage financing in both the United States and the European Union. Venture Capital funds are concentrating on larger and larger deals, leaving the small and risky early-stage deals asides… This can become a self-reinforcing cycle: because few venture capital funds are active in the seed and early stage area, they don't have any longer the necessary knowledge to operate there… the recognized benefits from the birth and growth of innovative small firms to the economies are such that public sector measures are justified to overcome this market failure…"
>
> (ECD-USDoC, 2005: 6)

To overcome this "market failure," programs like EIR (in Israel) should be examined by both practitioners (VCs and government agencies) and academicians. Our findings indicate that EIR programs are successful and that they help VCs in finding the right startup/seed deals for their portfolio. They also help VC funds keep the 7 to 10 percent of startup/seed investment level in their deal flow.

The framework discovered in this research shows the factors that make up the EIR program and their effects on cost. Practitioners can use this framework to start or polish their own EIR programs. Governments and academicians can use it to improve the field of equity gap research.

Challenges and Future Research

The research used to develop this model draws on qualitative data collected in Israel and on USA-based literature studies. It would be appropriate to test this VC approach (using EIR programs) to closing the equity gap in countries other than Israel. Fundraising, investment in buyouts and later stage investments take place in an extremely well-developed, globalised market. In contrast, when investing in startup/seed ventures (ECD-USDoC, 2005), there is a home bias in the activities of venture capital funds.

Another limitation was the small sample size: Too few entrepreneurs and angel investors were interviewed because of the narrow research question. Enlarging the research question to include inquiry into the price that entrepreneurs pay with the EIR program and what is happening to the angel investors in Israel may prove useful. Do EIR programs in Israel play the same role as angel investors in Silicon Valley? Are there fewer angel investors in Israel? Perhaps differences between cultures would explain why the equity gap is more dominant in some countries than in others. As an example, as demonstrated in Table 1, Israeli VCs differ from their American colleagues in their enthusiasm toward early stage/startup ventures in the ICT market.

Quantitative research is also recommended to compare results in different countries and cultures. Another area of interesting quantitative research would be to separate the effects of syndication and government incentives from the EIR program.

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APPENDIX A
Interview Script

Interview Script

Summer, 2005

Research Topic: Pre-Seed Stage Investment of Venture Capital Funds (in Israel): Entrepreneurs in Residency (EIR) Programs

Interview Introduction and Open-ended question.
Three types of questionnaires will be used:
VC fund partners
EIR entrepreneurs
Other entrepreneurs

INTRODUCTION to all interviews:

Thank you for receiving me and agreeing to be interviewed for my research (EDM Program at Case Western Reserve University) in Entrepreneurship. (Here I explain the program)

My study looks at VC funds that focus on initial stage and follow-on investments in seed stage projects (also angel/pre-seed projects). I am interviewing several VC fund partners and their early stage "entrepreneurs". I would like to include also examples of "not successful" ventures

SCRIPT:

1. **About the Venture Capital Firm**
    a. Can you tell me about this VC partnership?
    b. How many partners?
    c. How big is your fund?
    d. History of the fund?
    e. What industries do you invest in?
    f. Which Industries have "been good" to you?
    g. How many exits? (IPOs and Company sales)
    h. How many seed investments have you done?
    i. If yes, which ones?
    j. Have you done any angel level (pre-seed) investments?
    k. If yes, which ones?
    l. Do you usually invest "after" angel investors? Compared to the past?

2. **Personal questions**
    a. Have you:
        i. Served in IDF (Israel Defense Forces)
        ii. Computer Units;
        iii. Combat Officer

b. How would you qualify your previous knowledge/experience
    i. For Technological Prior Knowledge (TPK)
    ii. Managerial Prior Knowledge (MPK)

3. **About the EIR program**
    a. Tell me about your EIR program?
    b. When did it begin?
    c. What prompted it?
    d. Do you know some other EIR programs?
    e. Are they different?
    f. Do you think it has been successful? Why?
    g. If you were to start one over again, would you do it differently?
    h. What guidance would you give to a VC friend who was considering creating an EIR program?
    i. What guidance would you give to an entrepreneur friend who was considering joining an EIR program?

4. **(Open question for VC partner and entrepreneur). Could you tell me the background of the entrepreneur or VC partners in**
    a. How would you define a HIGH STATUS entrepreneur?
    b. *Do you consider him to have "HIGH STATUS"? if yes why? if no why?*
        i. Served in IDF (Israel Defense Forces)
        ii. Computer Units
        iii. Combat Officer
        iv. Technological Prior Knowledge (TPK)
        v. Managerial Prior Knowledge (MPK)
    c. *Grade his previous knowledge* in each of the following areas::
        i. Technology Knowledge
        ii. Network Development
        iii. Software Development
        iv. Hardware Development
        v. Educational Achievements
        vi. Market Knowledge
        vii. Customers' needs and problems
        viii. Industry trends
        ix. Management Experience
        x. VC relations
        xi. Served in IDF (Israel Defense Forces)
            1. Computer Units
            2. Combat Officer

5. **About the EIR based venture**
    a. Can you describe the venture?
    b. How much was invested at the beginning?
    c. Where ANGEL investors involved?
        i. If yes, did they help in any way?
    d. For VC partners only:
        i. How much of your time is/was spend on the venture's issues weekly?

    ii. Can you compare that with other ventures?

e. For entrepreneurs only:
    i. How much of his time is/was spend on the venture's issues weekly?
    ii. Can you compare that with other ventures you know/knew?
f. How would you put a value, at the present time, on the "venture"?
g. Value at next stage?
h. Do you consider it a success?
i. How would you measure it?
j. The (perceptions of the) relationship (mostly non-financial involvement) between the both of you
    i. Do you trust him? (how do you define trust)
    ii. How much of the relationship was based on trust?
    iii. Sweat equity invested in venture by other people connected to the VC fund (board, customers, banks, other people in the management team

APPENDIX B
Selected Quotes

1. Investing in ICT startup/seed companies (plus syndication):
–"*the big successes in venture capital are from early stage investing… that's why we do now early stage investing, and we target, the highest returns, we are expected by our investors to bring the highest returns*"-

–" *The whole VC game, especially when you are trying to get the high returns, the homerun, the big hits, only has to do with exceptions, if you follow any rule you'll fail, because it's only about, the statistics… they are very much against it, so trying to create any rule is just working against you*"-

–"*we brought together with us another fund, because we feel that usually we would like to have more "deep pockets" in addition to us …. we would like to support the company towards all its life span, we negotiated with them basically the evaluation of the company and how much will go to the rest in the syndicate"*-

–" *they came here with a napkin, and they've sat with us and they explained us what they want to do…. we sat together with them and we wrote, we assisted them to write a working plan. We saw that the system basically would not be viable and we changed their idea. Design components for systems of others, and the company is today a 20 million dollar a year company.*"-

2. VC expertise:

" *We felt that we really have to fold our sleeves and work with the entrepreneurs, and really not manage them on a day-to-day basis but be there and fulfill all their need., not necessarily just to increase sales and reduce expenses (we joke about some VCs that when they sit in a Board that's basically what they always say, and they eat good Pizza) all our VC partners came with a tremendous amount of experience and we work with all our companies… we have today about 16 startup/seed companies that we invested*"-

–"*We are originating ideas all the time from the incubator* group *(basically from my partner, myself and other people who work here in the group of companies in our portfolio) and may tell us about an idea that they need or they feel is needed…… then we bring in entrepreneurs… we also bring in management to start a company, and we invest in the company ourselves….. we take it forward ….., so we are very much involved in the beginning of the company, as the company grows we become less and less involved … we are still very active directors, even when the companies become public… we only invest in ICT, which is an area that we know and this is where we can trust our mind in generating new ideas that are sound…. we bring in VCs or other strategic investors along the way, we may or may not invest with them …. normally we invest only startup/seed stage money….., if we feel the company is worthwhile we keep on investing and help the other investors feel more secure… then we take the company public* "-

–"*We know how to help an entrepreneur build companies, we know how to help them recruit, we know how to help them figure out product marketing, market positioning, his* *strengths, his weaknesses and the competitive roadmap. We are active investors. It doesn't mean that we are management but we are active investors. Our strength is understanding the startup/seed ventures in the ICT industry. Later stage investment… it's a different skill set it's much more financial rather then industry specific"*-

3. VC's deal flow and EIR investments:

–"*to manage a large amount of money is a burden also, you need to find a lot of projects and that puts you in pressure*"-

–"We *created a company with the EIR because in order for him to get investments we have to create a company, we don't invest in people, we don't put money in the account of somebody "go ahead and do it!", it has to be totally transparent and controllable*"-

–"*If VCs have to invest a half million or a million dollars it's not interesting for them… they need to invest several millions in its life span ….. they need to have returns of five …, seven …, ten …. on the money because that's the role of venture capital"*-

–"We *don't invest in ideas, we don't invest in people, we don't invest in companies, we don't invest in concepts, we invest in DEALS"*-

4. Repeat entrepreneurs and failure:

-" *because entrepreneur is something that you should have in your blood, something in the DNA, it's not something that you can learn…."*-,

–"*I don't know if your chances of succeeding the second time are better than the first time or not, in some cases at least one company like this, the person has been tainted by the bubble, it was too easy the first time, so he started a company, did very well, had a nice exit but really didn't have to build anything, so you know, you make an assumption that that's how you do it, and it's not the case, you either have to build a real organization and have a plan that makes money and so on, it's not just developing the technology and getting it sold for half a billion – it doesn't work anymore*"-

–"*when you see an entrepreneur that you think is a good entrepreneur, a serial entrepreneur, someone that already had previous experience, a startup, it doesn't mean that he has been successful in the previous one, of course not, probably the startup hasn't done well but he is a good guy, … and you are convinced that he can do it again and learned from his mistakes"*-

-" *entrepreneur is someone that first of all understands how to go to the market, what to ask, how to make the business plan, and how to make validation of an idea, and how to raise money, of course you can not predict entrepreneurship in someone, without previous experience"*-

5. EIR programs and defining success as funding their ventures:

–" *nearly every one (VC funds) now has an EIR"*-

–" *Entrepreneur in residence is someone who is trying to build a company, is looking for an idea to become sort of an entrepreneur to take the idea from very early stage. Executive in residence is someone who was an executive in a company and he is mainly looking for a CEO position in a company that we will help him find together, and a venture partner is somebody who has his own activities and is affiliated with us, looking with us at opportunities, adding domain expertise, not necessary as a CEO or as a sort of an entrepreneur, but he might be personally investing or joining the board*"-

–" *I think, in the four and a half years since we started we looked at close to 1,500 companies and we invested in 24… investing in 2 out of 5 EIRs…. success is investing versus those we ended up not investing…. that's part of the program, it just shows that we take it seriously and we do look at it objectively…. so two out of five is still a much higher percentage of our normal investing percentage, our normal investing percentage statistics are 24 out of 1,500,… ….EIR is pretty successful if you are looking at how successful it is in generating plans that we are interesting in investing in'-*

–" EIRs?…. I would say we had 8, and 4 turned into companies, which is I think is a very high percentage. We pride ourselves of being, you know, the fund with the most EIR based invested companies"-.

–"*you really get three things: you get funding, you get access to the venture capital partners in the firm, which are usually very strong people in technology and business and the third thing you get is access to the people who are linked to the venture capital firm (use their network and their people to actually help evaluate ideas once we came up with ideas) that was very helpful."-*

-"You learn not to look at the VCs as the other side… the reality is that everyone is on the same side while checking the idea… obviously, later once you start discussing business terms there are two different sides … each side wants to get a bigger piece of the pie''-.

–" *EIR is a very risky proposition. Basically the idea of EIR is that you are going in without having an idea of what you are going to do, and it means that you need lots of, ability to change your business model and evolve over time.. first of all you need lots of flexibility in finding the idea, but then also you need lots of flexibility because you are going to change again many times before the first stages of the venture"-*

–"*in a market that is very competitive, assuming that the market is competitive, and that's my assumption, it (EIR) gives you actually a first look…. if the EIR is coming after the end of the incubation with a very exciting idea, I buy myself an option to be an investor there, which otherwise probably I would not be able to… I have the option to invest … it's not without price, there is a price…..not cheap, if you are doing a few EIRs and nothing happens in a year, … it's not cheap, it's also time consuming – you have to talk to them, to work with them"-*

–" *a strong EIR can bring a great network and help you find deals that you will not know about, that he knows about it just because of his position in the industry. There are a lot of benefits. It costs money, but there are a lot of benefits to it*"-

–" our Entrepreneur in Residence program is a little different than other funds, we have a "no strings attached" type of Entrepreneur in Residence program, it means that by hosting an entrepreneur here, and I am sure you already know, EIR is used both for Entrepreneur in Residence and Executive in Residence, we haven't done any of the latter yet; Entrepreneur in Residence we've done a few, as I said, it's "no strings attached" meaning that we host the entrepreneur here, we expect them to develop the plan that they have in mind when we bring them here, so we don't bring them here when they don't have a plan in mind, but we expect them to develop that plan into something that can be decided on as an early stage investment within 4 to 6 months…… when and if they do, then we have them present to us just like any other person coming through the door, and we try to make an impartial or objective decision, just like we try to make with anyone else, whether to invest or not. We do not take a right of first refusal, so the entrepreneur can decide, after he comes up with his great idea, not to show it to us for investment, he can take it to someone else to invest, although we hosted him. We pay him a monthly salary, very specific expenses that are required for his research work, building up his business plan, travel, research material"-

–" EIR is a clever way for certain VC funds to hang on to good entrepreneurs and give them a home, or a part time home for a period of time. So I've seen, a couple of different models of EIRs, both in Israel and in the Silicon Valley. I've seen the model where a fund has worked with an entrepreneur in the past who have done two or three startups, they've been successful, they would somehow like to maintain a relationship with that entrepreneur because he's done a good job, the entrepreneur isn't ready to commit to anything yet, he wants to take a little bit of time off, breath a little bit, take a look around, see what his next thing is going to be – so the fund gives him an office, it gives him access to their deal flow in case he sees something that attracts him, the fund also can have him handy in case they need a replacement CEO for one of the portfolio companies, so it's a semi-formal relationship, because rarely can you say to that entrepreneur in residence "you can't work for any other startup"'-

-" it's a good justification of your management fee…. a lot of the larger funds, the 500--800 million dollar funds, even at a 2% management fee, it's a very large operating budget. One of the ways to justify that operating budget is to have EIRs. There is a limit to how many partners you want to bring on, it's interesting that some of the larger funds say that at some point it becomes very difficult to manage the partnership if they want to expand beyond a certain point, it's too difficult… what they do instead is they look for effective ways to use their management fees, and one of the effective ways is to have EIRs. The EIR will help you evaluate deal flow, the EIR may attract some good deal flow, because of where he's been, what he's done"-

-"the high status EIR has a recognized name in Israel, did a superb job in his last position, it gives positive PR, brings in a lot of deal flow because a lot of entrepreneurs met him before"-

–" EIR in terms of advantages for the VC – first of all if it's a person they know…...a lot of things are around the people, and I saw several startups that came here and the VC thought the idea was good, the people were not suitable and they let it go…..maybe they

can take the idea to other people, an idea and a person don't have to go together, so if the team isn't good. They will not invest unless they can put there their own EIR…. a person who is good as an entrepreneur and can lead a company …… especially knows a particular market….. can do a lot with a good idea in this market……, he can make the idea happen"-

6. EIR and VCs from same backgrounds especially the Israel Defence Forces:

–"*fixing the valuation in this stage (startup/seed), validation takes a lot of time, very consuming, tedious, you have to talk , to people like you…*"-

–"where *you were in the army will influence my decision, those are filters that filter certain types of people. It's always when you have someone who came from a certain background that he went through certain things and did successful things,. it adds points*"-

-" *my impression was that the VC is going to be a great partner. So it was first of all that I wanted to work with the specific VC and also I was impressed by the partner and wanted to work with him personally…*"-

–" *You make deals only with very high status entrepreneurs, as an anecdote let me tell you, I told my wife that an entrepreneur was a fantastically credible person, hard working, smart and also handsome, so she asked me why I married her and not him… I have an ongoing argument with my wife whether or not to do business with friends. She says it is not worth fighting over. I say yes, with whom should I do business with, if not with friends*?"-

-"*There are some VCs who are really not part of the "old boys" network.. Entrepreneurs have a very different expectations from US based VC versus an Israeli one. He knows, that if he needs to hire some super duper software guy, young guy out of the intelligence corps – I am not going to help him with that. If he needs to get into a US company I can do it. What I've seen over the years is that Israelis have a better understanding today that a great product is a great product, but it doesn't get sold alone, if they want the contacts with the foreign vendors they need US based VCs"-*

-"*people need to have the experience of working together, know how they think, how they work, and there is a very high value to the fact that me and the VC partner, although we sit in different companies, we know how each other thinks, he is a board member, I am an executive, but I know where his good and strong sides are, and he knows where I need some assistance, even before I ask, and vice vers*a"-

7. Entrepreneurial team:

–" *the chemistry between the entrepreneurial team (among themselves) and with the VC has to be good …. but most companies fail, I think, because of inter-personal problems, it's not because of technology. You know, things don't go very well and things almost always don't go well at some point and then people start to blame each other and point fingers*"-

8. Conflict of interest between VCs and Entrepreneurs:

–"Some endeavors are great businesses, but do not make good investment for a VC. A good example, a very small market, you can make millions of dollars but it won't be a big market for a VC. Maybe the business just requires significant marketing investment; it can still be a good market but is also not a good thing for VCs. So basically by choosing EIR program you are limited to ideas that make sense for a VC."-

-" it happened to me several times in the process, we actually came up with ideas that were really good ideas and you can make very nice companies around those ideas, but were not a good fit for the VC and I had to abandon them. That's part of what you're taking on yourself when you are going with EIR."-

-"the due diligence was like nothing happened before, they just started from zero…. as the CEO or as the founder of the company, you don't really want to get any discounts in checking your ideas… the only thing that will happen is harm to both sides … as the founder you want to make sure that you're spending your time on something that makes sense and can make money, and as VCs they want to make their money work on something that make sense and then will make more money"-.

–" differences in interest between entrepreneur and the venture capital fund itself are many. Because, a company that can be interesting to me may not be interesting for them! …. company that can make millions and can be sold for 20-30 million dollars … it's good for me, especially if I have interesting equity there, but for the venture capital fund it's not interesting"-

9. Trust and trusting:

–" The VC partner understands where this track that I am using may take me…, he knows that if there are changes in the plans I will always speak with him early and consult with him, so basically he is not surprised by bad news, or by strange activities or things that could surprise him , because we've created some relations where his advice is useful."-

-" so we are getting into this process of working together, I like his ideas, his ideas fit my own way of doing business and they are also good"-

–"what is this trust? I don't know how to express it, because I sort of want to say very radical things. You trust such people (entrepreneurs) one hundred percent, one thousand percent, day and night. And almost every technological thing he says he will do, you trust him to do, plus minus the schedule, with perfect quality. I am pretty sure they hear similar things from me regarding agreements…… what to do with the commercial aspect, what to do with the bank. They also follow me blindly. I mean it is not an issue at all. No issue"-

–"I believe that eventually only someone who invests 150% of himself and more in the company might become essential. I have bad experience with advices of part-timers; I don't find this to be useful."-

–" we (VC partners and EIR) have a weekly 3 hour meeting, brainstorming on ideas and on companies, so I got my own ideas do some presentation and they give me feedback…… they said: "listen this week we are meeting with this company, we met this that company, does it interest you?" and we discuss the business mode of the company and sometimes we schedule other meeting during the week to see that company etc…… they also help me with validation, if I need to contact some … like vendors,, companies like Samsung or …… I needed to ask questions and to validate – they help me with their connection and it was very useful, very helpful. When you are outside of a VC and you think of idea, it's difficult, you know, you have to use your own connections and start, but here, when you are coming from within, you know, the money community, it's quite easy to get you any meeting you want, and it's like you are doing it in, you know, in a luxury environment, and that's really good"-

10. Government incentives:

*–"…in '85 we actually started, at that time we have done mainly what you call "corporate advisory assignments", "privatization", "advisory services" to the government, "company evaluation", and we tried all the time to raise money to a venture capital but it was useless until 1992, when the market in Israel got an inflection with the initiative of the government called "**Yozma**", which is in Hebrew "initiative" – it was a special program to leverage the funds, or equity funds that have been brought by investors, this was the first wave of VC funds in Israel, and since then we are engaged in venture capital funds, and we have actually spun all our other business and we are focusing today only on venture capital funds"-*

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