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Master’s Programme in Accounting

How do venture capitalists see their contribution as owners?

Observations from VC accounts on value-added actions and governance

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Jimi Jyväsjärvi

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Abstract

Venture capital (VC) is a key source of financing for entrepreneurial firms with high risk profile that do not have access to traditional financing sources. In addition to providing funds, VCs conduct various value-added actions to maximize the value of their portfolio firms. VCs are known as active owners that often hold significant control over portfolio firms, diverging them from the premise of the principal-agent model, where the owner's control over outcomes is limited.

As investors, VCs can be thought of as operating in value-added and control roles. Control role is based on contracts that VCs use to facilitate managerial intervention, whereas value-added role mostly stems from equity incentives. I interview Finland-based VCs and conduct a multiple case study to analyse how VCs ensure a return on their investment, and present general observations on how value-added role and control role are manifested in practice as seen by VCs.

I find evidence that Finland-based VCs support their portfolio firms especially in recruiting and legal matters, but more important value-added contribution comes from access to additional funding. The interviewees agree that contracts should serve as background frames for stakeholder alignment and that there should be no need to enforce them in practice. Instead, VCs promote reciprocal discussion in problem solving and recall that due to the experimental nature of ventures, formalities should be minimized. VCs help firms to develop their reporting so that they would be investable in subsequent financing events, but avoid creating unnecessary administrative burden. The team is where VCs eventually invest in, so they pay great attention to committing the key persons to stay with the firm and emphasize the importance of committing new hires as many venture firms have urgent recruiting needs as they build teams.

VCs are in business for profitable exits, which are typically their only source of return. My evidence from exit discussion suggests that even though standard contract terms are applied to prepare for exit situations, all firms make unique exit paths. Ultimately, the founding team holds remarkable power in the sale process because in many cases their skills is the firm's most valuable asset.

Keywords venture capital, corporate governance, VC

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Tiivistelmä

Venture capital on tärkeä rahoituksen lähde korkean riskiprofiilin yrittäjävetoisille yrityksille, jotka eivät saa rahoitusta perinteisistä lähteistä. Rahoituksen lisäksi VC:t maksimoivat sijoituksensa arvoa tarjoamalla erilaisia lisäarvoresursseja portfolioyrityksille. VC:t tunnetaan aktiivisina omistajina, joilla on usein paljon valtaa portfolioyrityksissään, mikä erottaa heidät päämies-agentti -mallin lähtökohdasta, jonka mukaan omistajalla ei ole suoraa kontrollia yritystoiminnan tuloksiin.

Sijoittajina VC:n voi ajatella toimivan lisäarvo- ja kontrollirooleissa. Kontrollirooli perustuu sopimuksiin, joita VC:t käyttävät mahdollistaakseen johdon toimintaan puuttumisen, kun taas lisäarvorooli johtuu pääosin omistukseen liittyvistä kannusteista. Haastattelen Suomessa toimivia VC-sijoittajia ja analysoin, kuinka he varmistavat tuoton sijoitukselleen sekä esitän yleisiä havaintoja, kuinka lisäarvorooli ja kontrollirooli ilmenevät käytännössä VC:n silmin nähtynä.

Aineistoni perusteella Suomessa toimivat VC:t tukevat portfolioyrityksiään erityisesti rekrytoinnissa ja lakiasioissa, mutta tärkeä lisäarvo syntyy erityisesti panoksesta lisärahoituksen järjestämisessä. Haastateltavat jakavat näkemyksen, että sopimusten tulisi toimia lähinnä taustaraamina osapuolten keskinäisille suhteille ilman, että siihen täytyisi vedota käytännössä. Sen sijaan VC:t suosivat vastavuoroista keskustelua ongelmatilanteissa ja korostavat, että kokeilevan luonteensa takia venture-toiminnassa muodollisuudet tulisi minimoida. VC:t auttavat raportoinnin kehittämisessä, jotta yritys olisi sijoituskelpoinen myöhemmin, mutta välttävät tarpeettoman hallinnollisen taakan luomista. Lopulta VC:t tekevät sijoituksensa tiimiin ja panostavat paljon avainhenkilöiden sitouttamiseen, korostaen uusien työntekijöiden sitouttamisen tärkeyttä, koska monilla yrityksillä on merkittäviä rekrytointitarpeita tiimejä rakennettaessa.

VC:t tavoittelevat onnistunutta irtautumista, joka yleensä on ainoa tuoton lähde. Exit-keskustelun perusteella kohdeyritysten irtautumispolut ovat aina uniikkeja, vaikka näihin tilanteisiin valmistaudutaan vakiomuotoisilla sopimusehdoilla. Tiimillä on käytännössä merkittävä vaikutusvalta irtautumisprosessissa, koska sen osaaminen on usein yrityksen arvon kannalta merkittävin tekijä.

Avainsanat pääomasijoittaja, yrityksen hallinnointi, VC

Table of contents

Symbols and abbreviations 7

1 Introduction 8

2 Literature review and theoretical frames 12

2.1 Introduction to VC 12

2.2 Value-added role 15

2.3 Control role 17

2.3.1 General 17

2.3.2 Contracts 19

2.3.3 Contingencies 23

2.3.4 Incentive structuring 26

2.4 Exits 28

3 Research design 30

3.1 Method 30

3.2 Selection and introduction of sample VCs 31

3.3 Data collection and analysis 33

4 Evidence from VCs 36

4.1 Value-added role 36

4.2 Control role 39

4.2.1 General 39

4.2.2 VC view on contracts 44

4.2.3 Contingencies 48

4.2.4 Contribution to incentives 52

4.3 Other observations 55

4.4 Exit discussion 57

5 Summary 62

5.1 Conclusions and discussion 62

5.2 Limitations and further research 66

References **69**
Appendices **72**
Appendice A: Figures 72
Appendice B: Interview checklist 72

Symbols and abbreviations

VC	Venture capitalist as an active subject, an individual representing a VC firm or VC firm itself
PE	Private equity industry, for simplicity divided into venture capital, growth, and buyout
LP	Limited Partner, allocates money to be invested by the VC

1 Introduction

Venture capital is a key source of financing for entrepreneurial firms that have limited access to bank loans and other traditional sources due to their high-risk profiles. High risks come with significant upside potential, which attracts VCs to seek for the best deals and entrepreneurs to join forces with and thereby to fill an important role in the financial markets. Kaplan and Strömberg (2001) propose that the important role of VC in market economy arises especially from their ability to solve agency problems, where entrepreneurs with good ideas need to be connected with investors who have money, but perhaps less good ideas. On the other hand, VCs might be relatively well informed investors that have strong industry knowledge, so it is rather their ability to take on risks and expose the value in experimental firms that distinguishes them as an investor group. At the extreme, they could be described as able to take "half-blind" shots that no one else takes. Although VC funding can be considered a meaningful signal of a potential idea, even the smartest investors on the field are frequently wrong as to which firms or business models eventually become winners.

Several studies find evidence that VCs are active owners who put in significant effort to support and advise their portfolio firms. VC influence is often "transmitted" through board, but in practice there can be a number of mechanisms by which VCs keep themselves informed and participate in ventures. Active VCs can be seen as balancing between advisory (value-added) and monitoring (control) role in portfolio firms, and participation in these roles can lead to a high degree of control over the outcomes from the VC's part (Kaplan and Strömberg, 2003). Hence, it is reasonable to expect that the agency model's idea of separating ownership and control might be a weak fit to VC relationships. Bedford and Ditillo (2021) have explored modes of control in private equity (PE) relationships from the perspective of PE firms. They challenge the conception that PE firms are distant

operators that only provide financial resources to invested firms. Rather, they find that PE firms are very involved in their portfolio firms and strive to build close and reciprocal relationships with the managers to help the firm succeed. As such, there are good reasons to expect similar findings from VC field, where similar proximity often prevails between investors and venture teams.

In this thesis, I study how Finnish VCs assume their value-added and control roles, and present general observations on what means they use to ensure a return on their investment.

I conduct a multiple case study of seven Finland-based VCs by interviewing them on selected themes including value-added actions, monitoring, contracts and contingencies, incentives, and exit. The selection of these themes is largely guided by what prior literature has found relevant concepts in VCs' value-added role and control role, but also the ideas that emerged during the interviews contributed to setting the scope.
The observations obtained through interviews provide interesting insight as to *what active ownership means in VC relationships and how VCs like to work with portfolio firms*. I find evidence that Finland-based VCs actively support portfolio firms especially in recruiting and legal matters, but the greatest value-added comes from improved access to additional funding. The sample VCs use contracts to protect their interest, and are relatively inflexible regarding certain terms, which can mean little room for negotiation. However, VCs share the view that contracts should only work as background frames for stakeholder alignment, and there should be no need to enforce them in practice, which highlights the VCs' appreciation for reciprocal trust and open communication. In addition to basic meetings the interviewees underline the importance of informal interactions, such as "keeping the line open" with managers for information sharing and support. Also, board and other formal channels can be ineffective in addressing matters that are truly relevant for venture firms. VCs help portfolio firms in

developing reporting systems to prepare them for subsequent funding rounds, but avoid creating undue administrative burden. In fact, reporting demand mostly comes from the LPs' side. Since a venture firm is often equal to its team, VCs pay great attention to committing key persons. Emerging firms typically have urgent recruiting needs, and new hires need to be participated in effective incentive structures, which the VCs design together with teams. Finally, exit discussions indicate that exit path is unique for each case, and stakeholders prepare for it from the beginning. Even though contract terms give the VC broad rights for exit situations, the interviewees note that in practice it is quite impossible to sell the firm over its team.

This thesis is primarily motivated by pure interest towards entrepreneurship and competitive market dynamics. Efficient financial markets ensure that best ideas obtain funding under all conditions, and even in hard times there are firms that grow and try to establish a strong ground for future innovation. VCs are not prone to wait until something happens before taking initiatives. Instead, they constantly ask what is next and how do they get there first. One could say that the best way to serve communities is to solve their problems, but first such problems must be identified accurately. As one climate change expert once put it: "*To see how market forces contribute to solving large-scale and societal issues, we should pay attention to what VCs are doing*." This thesis contributes to understanding what kind of investors VCs are and what practices they favor when working with portfolio firms. As the evidence is based on accounts given directly by the VCs, it also serves the information needs of current and future entrepreneurs about how VCs think and what to expect when working with them.

The remainder of the thesis is structured as follows. In the second chapter, I provide a brief introduction to VC investor profile and review key concepts that prior literature finds relevant concerning VCs' value-added role and

control role. In the third chapter, I present the case study method chosen for this thesis, introduce the sample VCs and their selection, and provide detailed description of the interview process. In the fourth chapter, I report the evidence from VCs and support the findings with direct interview quotes. Finally, in the fifth chapter, I put together the findings and discuss their implications and relevance against prior literature, concluding with proposals for further research on the topic.

2 Literature review and theoretical frames

2.1 Introduction to VC

Typical VC structure is a limited partnership, where partners as ultimate owners exercise the highest power. Other roles on VC teams can be principal, associate, and analyst, for example. As a limited partnership, the VC organizes its investing operation through individual funds, for which it collects money and capital commitments from its Limited Partners (LP) that are basically the VC's clients who allocate certain portion of their capital to be invested with VCs. LPs can be institutional investors, for example (Da Rin et al., 2013). By giving a capital commitment, the LP promises to deliver an agreed amount of funds to the VC when money is called into the fund. One important feature of VC investing is that the timing of cash flows between investors (LP) and fund managers (VC) can be very irregular depending on the investment setting. Once an investor has given a commitment to a fund, the money may not be called in for a long time. And, when it is called in, that may happen at irregular sizes and time intervals (BVCA Perspective Series, 2015).

VCs build trust by putting their own skin in the game by investing in a relevant percentage share of the fund. Management fees and other expenses are accounted for in the size of the fund, and they can make a notable share of the initial fund value over time. From the market perspective, the fund size can also be indicative of the VC's ownership strategy. By premise, a VC fund has a limited life, which means that its holdings must be liquidated to pay returns to LPs. However, in practice VCs may have means to adjust the fund's timeline according to their needs. Strong track-record in returns gives credibility, enables VCs to continue funding other projects, and likely attracts new LPs to invest with them. As in all investing, reputation built on

accurate judgment is important for the VCs to gather a strong network of LPs that are ready to commit money for future projects.

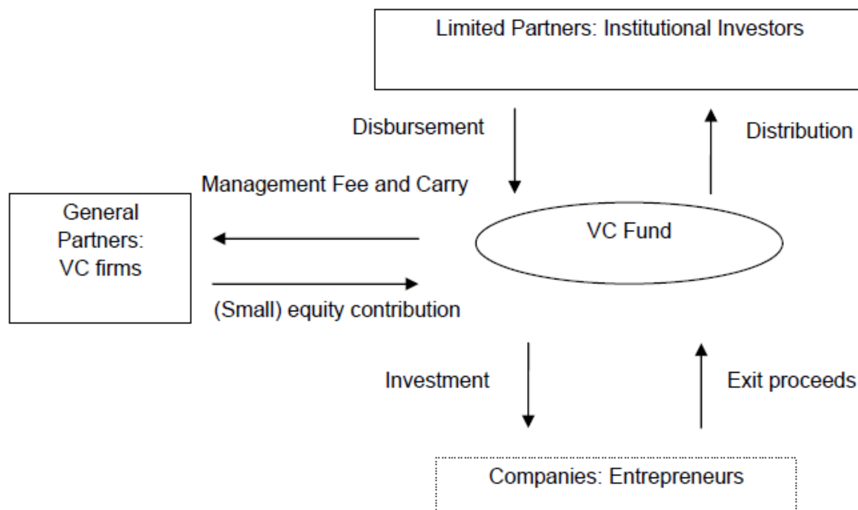

Figure 1: General VC structure (by Da Rin et al., 2013)

One VC fund is typically invested in a portfolio of equity stakes in venture firms through financing rounds, which is a process whereby private firms raise money from investors. Early rounds are often completed with only few external investors. For performing firms, later rounds likely involve more participants. After all, the fundraising process and its variables depend heavily on target firms and VCs involved in rounds. VCs invest primarily in equity stakes, but can also arrange the financing through debt instruments, such as convertible debt. A firm can aim to raise money from VCs when it looks to expand into many areas at once, for example, and such growth can not be funded by cash flows from operations. Kenney and Zysman (2019) talk about VCs helping firms to cross the “financial valley of death” where expenses rise sharply, and the income is too low in the beginning of the growth phase.

Provided that failure rates of VC portfolios are high, the required returns for winners can grow demanding. As a result, for each investment VCs must ask whether the considered firm can return the whole fund by the target multiple. For simplified illustration, a VC can raise a fund of 100 from LPs for whom it promises a 3x return (300). That 100 is then diversified as equally large investments (10) into ten firms. Assuming nine out of ten firms fail, the successful one has to make at least 30x return on 10 initially invested to return the whole fund. Hence, the higher the target return multiplier and failure rate, the greater return must be achieved with the firms that succeed. The illustration does not account for management fees and other factors that affect the return distribution of the fund, but outlines the power law whereby a small minority of VC investments generate most of the returns.

The worldwide VC industry is a relatively small fraction of the aggregate financial markets. VC market can be considered a relatively unstructured subgroup of private equity market, which is usually divided into venture capital, growth, and buyout, though clear lines are sometimes difficult to draw between the three. The main differences between traditional buyout investors and VCs are usually related to targert ownership share, financing instruments, and maturity of the target firm. Growth equity in turn falls somewhere between the two. Bedford and Ditillo (2021) present that PE operations can involve substantial use of leverage and target firms are generally more mature and possibly undergoing a market expansion, restructuring, or other special situation through which PE investors strive to extract value. VCs in turn typically specialize in start-up or early-stage firms with high growth and market potential, and do not employ debt to the extent that PE investors might do, nor take a majority ownership (Kaplan and Strömberg, 2009).

Separation of venture capital and buyout is often workable as buyout refers to the investor buying previous owners' shares in the firm to obtain majority

control, whereas in VC relationships founders mostly retain significant ownership (Da Rin et al., 2013). Nevertheless, there is no perfect model for either one as their strategies, investable funds, and other characteristics vary greatly across market participants. Ultimately, any investor that allocates money into private entities could be classified a private equity investor. As mentioned, in most cases buyout firms' majority ownership enables them full control over the firm. On the other hand, a minority owner with bargaining power can use contractual structures to obtain strong control rights. For example, VCs holding minority stakes can demand control rights to be allocated so that technical ownership shares does not matter as to how the firm is governed.

VCs' operational cycle can be roughly divided into three phases: deal sourcing, deal selection, and post-investment actions (Gompers et al., 2020). This thesis touches certain matters of deal selection, but focuses on post-investment value-added and governance actions that VCs take for the benefit of their portfolio firms. Also, further details of the securities used in VC investments are out of the scope of this thesis, though some of their features are raised in connection with contracts.

2.2 Value-added role

It is widely acknowledged that modern VCs provide portfolio firms with various resources other than financing, although these processes can be mostly unobservable (Da Rin et al., 2013). Such resources include support in business planning, recruiting, and negotiations, for example. Gompers et al. (2020) study VC decision making and name activities such as "strategic guidance" and "operational guidance", but provide little details about their substance. One popular idea is that the VC brings in its extensive network to help develop the venture. The value of networks mostly comes from recruiting and financing capacity. That is, VCs can use their networks for

searching new team members to portfolio firms or bring together investors for a financing round. The benefits of networks can be substantial in controlling the risk for adverse selection in recruiting. Since there is little sense in conducting careful manager search without control rights over recruiting decisions, VCs only add value by introducing new managers if they can call changes to the portfolio firm management (Hellmann, 1998). External, nominally independent professionals can also engage with the team for training purposes, for example. Zahra and Filatotchev (2004) suggest that in firms operating in complex environments corporate governance can be used as means to supplement the entrepreneur's capacity by taking advantage of external expertise. In venture context, this could mean inviting industry experts to join the board so that the team would have access to informed advice and relevant people.

Kaplan and Strömberg (2003, 2004) distinguish between value-added support and managerial intervention and present that contract design affects the VC's ability and incentives to conduct such actions. They find that managerial intervention is not strongly related to the VC's equity stake, whereas value-added support and equity stake are positively related, which supports the idea that value-added actions stem from equity incentives. On the other hand, a VC that holds more equity incentives also carries more risk, which could give a reason for more intervention from the VC's side, and thus blur the line as to whether an action should be counted as support or intervention. After all, VCs seem to require a decent compensation (large equity holding) for their work with portfolio firms, so it could be expected that VCs are reluctant to take very small minority stakes (Kaplan and Strömberg, 2003). From further agency perspective, value-added actions are likely to be beneficial for both the firm and the team, whereas managerial intervention benefits the firm but possibly at the expense of the team (Da Rin et al. 2013).

Value creation methods are currently seeing fast progress as great amount of business development expertise keeps entering the field. The problem in smaller markets is often that capable people and relevant professional services are limited, but the future outlook is mostly positive in countries such as Finland whose ecosystems of emerging firms are positioned well in attracting capital and talent.

2.3 Control role

2.3.1 General

Corporate governance provides a framework of practices for arranging the relationships between the stakeholders of the firm so that the firm can deliver efficient outcomes. When direct control by the owner (principal) is impractical, the principal and the agent enter into a contract whereby the agent will manage the firm, and should behave in the best interest of the principal. Since the principal is not assumed to have direct control of the outcomes that follow from the actions of the agent, she should try to align the agent's interests with her own. These are key underlying principles of the principal-agent model by Jensen and Meckling (1976).

Traditional corporate governance research largely focuses on general links between governance practices and firm performance, though it has proved challenging to reveal consistent effects of certain governance structures on financial performance, such as board composition, for example (Aguilera et al., 2008). There is also a broad base of VC studies exploring financial contracting and governance structures associated with VC ownership, trying to identify causal effects that VC funding has on a firm (Da Rin et al., 2013). Hellmann and Puri (2000, 2002) find that VC-backed firms have been able to decrease the time required for product launches and develop sophisticated compensation schemes, indicating that there is a relationship

between VC ownership and effectiveness in execution. Moreover, Puri and Zarutskie (2012) report that VC-backed firms are more likely to file for an IPO, and less likely to go bankrupt.

In principle, ownership structure affects the financial and governance structures of the firm, and ownership share often is a useful proxy for who controls the firm. However, nominal ownership may not reveal much about the control mechanisms that actually steer the firm or how the influence of different stakeholders is channeled within it by information sharing and other means. VC-backed firms typically have a concentrated ownership structure where the founding team holds a large equity share while the VC is a minority owner, which suggests low managerial opportunism. VCs need to resolve how to get information from the venture for monitoring purposes while its reporting practices might still be in progress. Therefore, in the beginning of the investment period monitoring costs can be very high for the VC if the portfolio firm does not have appropriate reporting systems in place. In addition to securing ex ante information rights by contractual means, building a reciprocal relationship with the team is important to get and maintain access to firm-specific information. Reaching a common ground in cooperation can also make it easier for the team to accept more rigorous goal setting for both short- and long-term performance (Bedford and Ditillo, 2021).

VCs can exercise board rights and voting rights to influence actions that are not specified in advance in contracts, and their active participation in board work and other monitoring is a significant mechanism in controlling agency costs. According to Kaplan and Strömberg (2003), VCs are more likely to have board control (>50 % of seats) in portfolio firms that have no revenue, and thus could push any decision through in formal board voting process. Possible reason for this could be that pre-revenue firms typically raise capital for product development, in which a VC can provide support, but also wants to ensure enough influence on the actions the venture takes with

that money. Furthermore, information asymmetry and risk are greater in such ventures, which makes incentives more problematic if the VC has significant control, but the venture is dependent on the team's contribution. Information asymmetry could be reduced and possibly more control retained with the team if it has a proven track-record with prior ventures, which is often not the case (Kaplan and Strömberg, 2003). Importantly, board control does not necessarily follow from a large equity stake, and the VC can obtain such control by appointing board members that do not work directly for the VC but can not be considered fully independent. Another question is to what extent the VC considers formal board control a relevant factor in practice if it has veto rights over certain actions. In other words, as a minority owner the VC can contractually build its position so as to it has de facto control over relevant actions. Kaplan and Strömberg (2004) suggest that the more the VC has board control the more intervention can be expected, and board control is associated with not only greater ability but also tendency to intervene in portfolio firm management. Yet, the VC might have strong incentives to refrain from using formal voting force or hard contractual means that could cause great harm for the parties' future relationship.

2.3.2 Contracts

VC contracts define the rights and duties between the VC and other shareholders. They are observable outcomes that result from negotiation between the VC and entrepreneurs striving to build a value-maximizing contract. Contracts are primarily used to allocate different rights related to cash flows and control, for example. Importantly, from the control role perspective contracts serve as tools to facilitate managerial intervention, which is why VCs' general tendency to employ contractual controls and incompleteness of contracts are relevant considerations (Kaplan & Strömberg, 2003).

One key question is whether there are universal contracting solutions that VCs find effective to the extent that they are widely used in the industry. The choice of contract terms is typically driven by largely unobservable firm-specific characteristics, which is why contracts are eventually endogenous. For this reason, the correlation between contract terms and portfolio firm performance, for example, can result from differences across VCs and portfolio firms instead of poor contracting (Da Rin et al., 2013). Hence, firm-specific factors that affect the VC's contracting choices are important in understanding the outcomes of contracting. This approach is consistent with contingency thinking presented by Aguilera et al. (2008), which accounts for context-specific factors and differences between firms in governance arrangements. On the other hand, Bengtsson and Bernhardt (2012) find that the most basic VC contract terms vary relatively little between VC firms and are actively actively recycled to be used with new portfolio firms. They provide evidence from over 4500 contracts indicating that VCs trust certain term structures on especially cash flow and control rights, and that VCs do not tailor contracts very specifically for each portfolio firm.

If certain term combinations are trusted by VCs, it is not surprising that VCs might leave little room for negotiation on such terms. Gompers et al. (2020) find that VCs are relatively inflexible on terms related to liquidation preferences, board control, and valuation, for example. On the other hand, VCs in their sample indicate some flexibility on terms related to option pools and pool participation rights. As illustrated in Figure 2, a typical VC in their sample is found as not very flexible in setting investment terms. Industry-specific characteristics should be considered when interpreting the figure, which serves here as an example of VC views on certain terms and lists items that are addressed in their contracts.

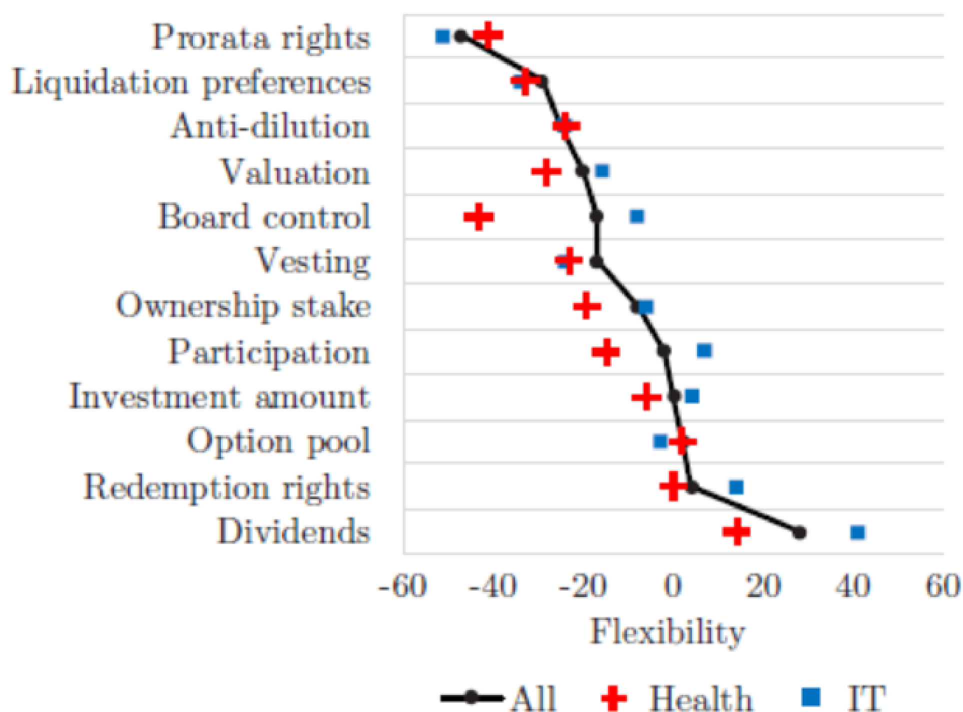

Figure 2: Term flexibility as reported by VCs (by Gompers et al., 2020)

VCs generate returns primarily through exits, so they must ensure that they are able invest more in the winners in their portfolio to meet return targets for the whole fund. Hence, it is understandable that VCs tend to be very strict regarding *pro-rata rights* that allow them to participate in a subsequent financing round (follow-on investments), and thereby maintain their ownership share at the level it was prior to that round. This is essential because VCs allocate some of the fund's capital for follow-on investments, but there are likely other participants in possible future rounds as well and VCs do not leave their seat unsecured. That is why the first VC investments are often called "*tickets*", which can be taken as an option to invest more in a particular firm. Missing out on follow-on investments can be costly for VCs, but one likely problem is that especially in situations of emerging markets and highly asymmetric information, the decisions may need to be

done based on very limited information as to the potential of the portfolio firm's business model or its target industry vertical. As a result, VC operations may sometimes seem "shotgun shooting" from outside perspective, though risky bets are an inherent feature of the industry.

Cash flow rights basically define who gets money out from the firm and on what terms. The structure of cash flow rights might be complex in some ventures. VCs are typically issued preferred shares that ensure they get their money back first if the portfolio firm is acquired or liquidated otherwise. Such *liquidation preference rights* are very standard components of VC contracts, though they can be srict from the other shareholders' perspective. For example, it is possible that the venture must be valued above certain threshold at the time of the exit so that other shareholders would get proper returns after the VC has gotten its own. Further details on liquidations and venture cash flow structures are out of the scope of this thesis. A notable point here is that the VC's position can be quite similar to that of a debt investor if it has a preferred claim to the portfolio firm assets (Da Rin et al., 2013).

Contractual control rights might have limited role in ex post control activities if the parties agree that it is more important what happens over the course of building and maintaining solid relationships. Although certain control activities were not based on contracts, they may have significant impact on the venture. Such non-contractible controls play an important but mostly unobservable role and can not be enforced in legal process (Bedford and Ditillo, 2021). In VC relationships, they refer to any informal means of cooperation and information sharing that is related to managing the venture. For example, the VC may take informal phone calls to keep herself informed and advise the portfolio firm CEO. Such actions are largely unobservable, but might affect to observable outcomes because they likely steer the actions taken by the agent. Therefore, research on control could be

supplemented with further exploration of non-contractible controls alongside contractual controls.

2.3.3 Contingencies

Incomplete contracting theories that are based on bargaining activity between contracting parties fit well to VC relationships as VC-backed firms face constant uncertainty and need to adapt as conditions change. Here, incompleteness refers to the premise that contracts can not be written so that they would perfectly address all potential scenarios the parties might face. Since the parties do not have exact information on what will happen in the future, there is always a possibility that once they obtain new information, they may strive to renegotiate the initial contract. In some cases important variables must be left out of the contract if they are difficult to define because including all necessary items would be too costly (Kaplan and Strömberg, 2001; Aghion and Bolton, 1992). On the other hand, contracts may include very general-level clauses to which an observer can find relations while examining the VC's actions, although those actions were not explicitly defined in the contract. For example, a provision stating that "*Any member of the VC team is allowed to work with the management in matters related to business*" incorporates numerous meanings of VC participation, but does not explicitly state such actions.

Contingencies can be defined as future events or circumstances that are possible but cannot be predicted with certainty. Contingency terms are typical components in VC contracts to prepare for specific future events, and they can lead to reallocation of rights if the contingency is met. For this reason, a typical VC contract might be heavily focused on contingency terms. For example, poor portfolio firm performance can result in the VC exercising contractual provisions that allow it to intervene (Kaplan and Strömberg; 2003, 2004; Aghion and Bolton, 1992). A simple basis is that

the more uncertainty is associated to the portfolio firm, the more the VC will demand control rights to protect its interest. Different risks are relevant to different VCs, however, as well as the metrics to measure them. Control can typically transfer to the VC by two mechanisms: explicit state-contingent shift of control that is specified in contracts, and dilution of control as the VC makes follow-on investments in the portfolio firm. The major difference between the two mechanisms is that contingency terms allow the VC to obtain more control without having to increase its quity stake (Kaplan and Strömberg, 2003). Follow-on investments can be considered a major reason for the result that VC control increases along the progress of VC-entrepreneur relationship. However, there is also contrasting evidence suggesting that control would gradually shift to the entrepreneur as the firm achieves desired results (Da Rin et al., 2013).

The challenge in studying contingencies is in that they can basically mean any future state the firm might face, so they can not be perfectly addressed by contracts. According to Kaplan and Strömberg (2003), the selection of contingencies is significantly affected by market conditions and firm-specific factors. They also report that variation of contingencies applied in contracts is high between VC firms, thus challenging the idea of relatively standard nature of VC contracts. Moreover, practical verification of contingencies can be difficult and subject to disputes, so the VC would only use them when it has sufficient control on the contingency criteria. Thus, decision control on whether the contingency is met is important especially when the attributes of certain contingency are not explicitly observable (Kaplan & Strömberg, 2003). Even if contracts could not be made contingent on a defined future state directly, they can be made contingent on a verifiable signal, such as an agreed variable representing short-term performance (Aghion and Bolton, 1992). For example, if “unsatisfactory growth” is a future state, it can be verified by the firm’s order log that is below an agreed reading. Financing rounds are also good examples of

contingencies because their timing is uncertain and there can be certain conditions to be met before the round is arranged.

Control rights can be made contingent on performance measures independently of cash flow rights. This is very important from the incentive perspective as the entrepreneur can be expected to be more comfortable knowing that if the current business plan fails, she would not immediately lose some of her equity-based benefits, for example. In other words, the VC can signal to the entrepreneur that no direct personal loss will follow from failure, but the VC needs to be able to obtain more control if the performance turns poor. Hence, increase in VC control would also mean extending the future states where the VC can obtain more control. Then, adding written contingencies to contracts reduces the future states where the entrepreneur retains control (Kaplan and Strömberg, 2004).

The contracting parties may strive to reduce contract incompleteness by setting contingencies that affect the rights related to future financing events, for example. VCs typically expect to invest more money in follow-on rounds if the portfolio firm performs, and staged financing gives early investors bargaining power for subsequent rounds as they can influence who participates in the round, for example (Da Rin et al., 2013).
Staging is a conventional tool for VCs to control for risk while allowing them to create returns through real options that enable an investor to do something with firm A that would have not been possible without making the initial investment in firm A (Sahlman, 1990). In VC context, such real options are crucial so that VCs can invest more in their winners.
On another note, competition for limited follow-on funds creates value for the VC as it sets strong incentives for the entrepreneurs to outperform other portfolio firms to strengthen their bargaining power (Inderst et al., 2007).
Finally, staged financing also works as a powerful control tool as it gives the VC a greater ability to force liquidation if the performance terms have not been met (Kaplan and Strömberg, 2003).

2.3.4 Incentive structuring

Equity-based compensation is a key component in aligning incentives for emerging firms. The team members' large equity ownership is often self-evident requirement to reduce the VC's agency cost, provided that the team is assumed to be best informed about the firm and responsible for operational performance. On the other hand, the team's equity stake likely dilutes with new funding rounds as more investors join the firm, which can pose challenges if the team members lose motivation as they see their ownership share shrink. To offset this problem, the team would expect a proper share in an upside scenario after liquidation preferences are settled.

VCs favor *time vesting*, which means that substantial proportion of the entrepreneur's total compensation depends on the time she works for the firm. Kaplan and Strömberg (2003) present that the main objective of compensation planning for venture firms is to commit the entrepreneurs to stay with the firm, and that time vesting is very frequently employed incentive scheme. The team's headcount does matter since the more there are, the more likely they will disagree at some point, which might result in human capital leaving the firm. Time vesting can also be considered a contingent mechanism. Aguilera et al. (2008) set forth resource-based contingencies and recall that governance practices can work as important tools for motivating critical employees. Assuming that the VC knows that retaining an employee is important for the firm, it can account for this firm-specific factor by making it expensive for the employee to leave the firm (Kaplan and Strömberg, 2003). Given that venture firms often have urgent recruiting needs, they need efficient schemes to ensure commitment of new team members. New hires may have much lower threshold to leave the firm as it is probably cheaper for them than for the founding team members.

Leaver terms are included in contracts for situations where a key person wants to leave the firm. These terms usually concern the shares owned by the leaver (potential source of compensation). For example, if the person is considered a good leaver, her shares can be redeemed at fair value. By contrast, in bad leaver situations the key person's shares can be redeemed at lower than fair value or on even worse terms. The criteria for a good leaver and bad leaver depend on contracting parties and are highly subjective, which is why they are difficult to explicitly define in contracts. Good leaver terms can be applied if the person is leaving for human reasons, whereas bad leaver terms can apply in any situation where the person does not show commitment to the firm or has lost trust, for example.

One premise suggested in prior literature is that the greater the information asymmetry between the VC and the entrepreneurs, the more the entrepreneurs' compensation should be tied to performance. As discussed around contingencies, information asymmetry is clearly demonstrated in the example of an inexperienced entrepreneur whose capabilities are basically unknown to the VC. Kaplan & Strömberg (2003) suggest that consistently successful serial entrepreneurs that have proven themselves receive less performance sensitive compensation packages, let alone the reduced likelihood for adverse selection, which the VC would presumably appreciate. On the other hand, in order to better control agency costs, VCs can even screen potential entrepreneurs by offering compensation contracts with quite extreme pay performance sensitivity to detect who would be willing to accept the terms since it can signal good entrepreneurial qualities. However, for human reasons the risk of an entrepreneur overestimating his skills is common, which is why the agency model's assumption of the agent having full information on her own skills and opportunity costs is rather idealistic (Kaplan and Strömberg, 2003).

The more complex the environment or business model, the more human capital is required, which makes committing the entrepreneur crucial as the firm may be highly dependent on her knowledge or skills. Difficulty of execution is an inherent risk in venture business, which stems from the fact that there are few skilled entrepreneurs for certain tasks (Kaplan and Strömberg, 2004). Such risk is evident especially when the firm is developing unproven solutions and the industry outlook is highly uncertain. In addition to financial compensation, there can be various non-monetary incentives. For example, the entrepreneur could think that by delivering strong results she would eventually "get her firm back" under her own control after contributing to a profitable exit for the VC (Kaplan and Strömberg, 2003). This could follow from the entrepreneur's logic that the firm needs money and professional advise to take the next step, but it would require selling a stake in the firm. Then, the entrepreneur would see that the VC ownership will be temporary as it ideally is, and after successful VC exit the entrepreneur would move on with the firm with all the learnings gained from the relationship with the VC.

2.4 Exits

VCs typically exit portfolio firms through acquisitions, IPO, or failure. Precise time frame from the initial investment to exit is quite impossible to agree in advance by contracts, but general exit terms can be written in detail for situations where an exit seems possible, and the parties decide to work towards closing it. Typically, VC contracts include *drag-along* and *tag-along* terms that affect also other shareholders' position in the exit. Drag-along gives a VC the right to force other shareholders to vote in favor of the sale of the firm, at the same time and on the same terms with the VC. On the other hand, other shareholders may try to negotiate additional terms on drag-along. Such terms can also include a minimum valuation threshold that the buyer's offer must exceed before a drag-alond term can be

enforced. Tag-along in turn gives other shareholders the right to sell their shares on the same terms as the VC in case the VC decides to sell its shares (Da Rin et al., 2013).

After all, the main purpose of drag-along and tag-along terms is to prevent hold-up problems in situations where the VC needs to liquidate its position. Hold-up problems refer to situations where it would be efficient for the contracting parties to contribute to their relationship to the extent that the benefits of that relationships would be maximized for the parties, but for some reason they do not do so. This could be due to one party being reluctant of giving relevant information to the other because that could reduce her bargaining power (Hermalin and Katz, 2009). In venture context, hold-up problem may realize if the founders holding large ownership are reluctant to sell the firm. The buyer normally wants to have discussions also with the team, and they could use the chance to give a different view about the firm, which can influence the buyer's plan on acquiring it (Kaplan and Strömberg, 2003). As a result, in practice VCs have strong incentives to reach mutual understanding with the team about selling the firm to avoid signaling badwill, regardless of the finding that exit-related terms almost always work in favor of the investor, and are used more when VCs see the hold-up problem more likely (Bienz and Walz 2010).

3 Research design

3.1 Method

I conducted the research by following a case study design where each VC firm (investor) represents one unit of analysis. The study could have been made by simple surveys, but that could have resulted in VCs only listing practices they favor without further reasoning as to why they perceive such practices fit in certain contexts. This "superficiality problem" can be addressed through more accurate fieldwork as surveys could only provide a thin view on management practices. For studying VCs, case study method provides more practical understanding on how they work with portfolio firms and why (Scapens, 1990). For example, VC-backed firms likely have formal governance schemes in place, but it can be largely unobservable how the VCs and venture teams implement them in practice. A case study can be very useful to study such phenomena, which is why it is the method of choice for this thesis.

To obtain sufficient depth in the analysis, I conduct semi-structured interviews with VC representatives to collect the data. Provided that the objective is to make general observations about the VCs' contribution in portfolio firms, I look for evidence on mechanisms by which such contribution takes place in practice and how VCs justify their actions. Importantly, my purpose is to study *similarities* in VC actions rather than looking for differences between them. Since I aim to present what is happening when VCs work with their portfolio firms including consideration of "hows" and "whys", the study is a mix of descriptive and explanatory case study (Yin, 2011)

The evidence obtained on any theme in the study is a representation of how a particular VC sees that theme and its implications. For example, a VC may hold board seats in different firms, which is observable from outside, but

the same VC may also report that board work is not very important channel for her to influence the firm. As a result, a VC holding a board seat does not necessarily imply that such VC considers board seat an important tool for influencing the firm. I compile the evidence around specific themes, which I have selected based on what prior literature has found important concerning VCs' value-added role and control role. In addition, I have utilized the ideas gotten from the interviews to support the selection of relevant themes. For additional curiosity, I ask the VCs to share their views on exit as it typically is the only source of return for them. Exit discussion provides insight on matters such as what makes a great exit and what possible pitfalls might occur around the process. The fourth chapter (Evidence from VCs) is structured by these themes.

3.2 Selection and introduction of sample VCs

For sample selection, I reviewed the listing of Finnish Venture Capital Association (FVCA) member firms on the association's website, and went through firm-specific websites to collect information on their investor profiles, assets under management, focus areas, and alike characteristics to identify VCs that invest in emerging entrepreneurial firms. Since it is difficult to distinguish between VCs, the sample selection is not guided by strict limitations in terms of industry focus, available capital, or other similar factors. For example, base capital and number of portfolio investments might not tell much about how the VC participates in its portfolio firms, though they can be good indicators of available resources. Due to significant variation in portfolio sizes and generally limited information on portfolio firms, the only sample criteria are that the VC reports itself as an active owner and that it invests in minority stakes. It is reasonable to treat *active owner* as very flexible term in studies, whereas *minority stake* can often be set at ownership of less than 50 %. This rules out pure buyout investors that acquire majority stakes in target firms,

though their value-added actions can be very similar to minority owner VCs. Importantly, there is a clear early-stage and technology focus reported by five out of seven sample VCs, though all define themselves as relatively flexible as long as the target firm's life-cycle stage fits to the scope of the fund.

The final sample comprises of seven Finland-based VCs with aggregated assets under management and capital commitments totaling hundreds of millions of euros. Geographically they focus mostly on Finland and Nordics. Several sample firms have internatiol team members and they seem to favor low-hierarchy organizations. As shown in Table 1 below, *technology* is the target industry for most VC firms, though specialization within technology varies across the sample.

	Firm A	Firm B	Firm C	Firm D	Firm E	Firm F	Firm G
Structure							
Team size	>10	<10	<10	>10	<10	<10	<10
AUM	>100M	>100M	<100M	>100M	<100M	<100M	<100M
Funds	3	3	1	3	3	1	1
Active investments	65	13	5	92	64	2	8
Policy							
Target industry	Technology	Technology	Technology	Technology	Technology	Open	Open
Target stage	Seed-	Early-	Early-	Early-	Seed-	Early-	Growth-
Target ownership share	10-15%	20-40%	10-20%	15 %	4-10%	20 %	15-25%

Table 1: Characteristics of VC firms

3.3 Data collection and analysis

To collect the data, I conducted a one hour interview with each VC in my sample. The interviews were done fully online but in an interactive manner. All interviews were recorded and transcribed. I made initial contact to VC firms via email and requested that the persons participating in the interviews would have experience and active roles with portfolio firms. The majority of interviewees hold influential positions within their firms and have years of experience in VC industry. Some of them also have background as entrepreneurs, which suggests good understanding from both sides of the table in VC relationships. I built the interview checklist (Appendix B) around selected themes related to governance and value-added activities, and sent it to all interviewees in advance to allow better preparation and possible clarifying questions. I also informed the interviewees that the checklist is in place to ensure all topics are addressed, but otherwise the discussion is open and my intention is to “let practice speak”.

The first phase of each interview included introductory questions about the VC firm itself and its investment philosophy. The purpose of these questions was to get an idea as to how prominent operator the VC is in its focus area and what it looks for in selecting investments. In addition, I looked for possible exceptional weightings in investment selection, that is, other factors than a great entrepreneur team, product, industry outlook, and growth potential, all of which can be considered quite popular qualities for a good investment. Also, target ownership stake and its meaning were discussed to chart in what range the sample VCs ownership stakes vary. In this phase the interviewees could also take time to share something relevant about their own backgrounds, which provided valuable information given their prior experiences in building firms or as entrepreneurs.

The second phase was dedicated for the VCs' detailed views on value add and governance aspects. I put focus on themes such as board work, operative support, contracts, monitoring, and incentive design. As for value add, I framed the discussion broadly by asking what resources the VCs provide to their portfolio firms. Obviously, great variation could be expected in the answers. My point of interest was, however, the VCs' view on what resources the portfolio firms need the most instead of the whole range of resources they could provide. For a simple example, a VC might be able to provide recruiting resources for any of its portfolio firms, but in practice its portfolio firms might need support mostly in legal matters such as supplier contract negotiations. For governance matters, I framed the discussion around the question "*How do you influence the following matter X in your portfolio firms?*" to get insight how the VCs see their own effect on each theme and encouraged the interviewees to give examples and reasonings for *why they think something works or does not work* when working with portfolio firms. In other words, I asked the VCs to set forth their best practices and to share if they believed certain aspects were very broadly relevant in VC relationships. I also presented follow-on questions where the interviewees' answers highlighted interesting concepts that could broaden the scope of the discussed theme. This phase applies very similar lines to those set by Bedford and Ditillo (2019) as they examined the relative importance of different modes of control in PE relationships.

Put simply, the key was to discuss freely on what channels VCs prefer to keep themselves informed about what is happening in the venture, and, if any intervention is needed, how such actions are put into effect. It must be noted that here the term *intervention* refers to any action from the VC side for any reason, so it is not only about blocking moves that VCs see poor for the venture. Provided that setbacks in highly uncertain venture business are quite inevitable, I asked the interviewees to reflect on their tools for managing relationships with portfolio firms in hard times, and whether contracts have de facto role in solving for management disputes or

situations where the firm's poor performance suggests that changes are needed. Finally, I collected the VCs' takes on committing the team and how they help portfolio firms to build effective compensation packages by combining salary income and stock upside.

The third and final phase was devoted to exit discussion and possible other matters the VCs wanted to raise, such as the effects of ESG measures in portfolio firms.

To analyze the interview data, I set a simple matrix where rows represent the discussed themes and columns represent the sample VCs. The structure allows for detailed comparison of VC takes on different themes across the sample. The objective of the analysis is to present general observations on how the sample VCs ensure they get a return on their investment and comment the findings in the light of prior studies on how VCs work with portfolio firms. To achieve this, I strive to identify popular practices among the sample and why these practices are seen effective and important. Importantly, such approach leads to look for similarities over differences. By definition, corporate governance can refer to basically any institution that helps to ensure the investor gets a return on his investment. Therefore, in a way value add actions could be counted under the term as well as control actions. Ultimately, the practices employed form the governance structures between the VC and its portfolio firms. No structure is similar, but some concepts likely prove to be workable in multiple settings.

4 Evidence from VCs

4.1 Value-added role

VCs provide advisory and support to portfolio firms to increase the value of their holdings. Staying closely involved can enable VCs to better influence the outcomes compared to taking the role of more distant owner. Value-added role can cover a range of actions from operational participation to financing solutions.

> *Nowadays value-added contribution comes first. I see that VCs essentially join in to fund the entrepreneur's vision, and we offer experience and advice down the road." (Firm D, G)*
>
> *"At start, support in business development such as client acquisition is more important, and we help the firms to focus on right things. Our whole team is available for support here." (Firm E)*
>
> *"We have a broad network ready to support, open doors and make introductions. There are top-brain people with knowledge on certain technologies that can help our firms." (Firm F)*
>
> *"Our activism is very firm-specific. Say, in very lucky case we can put most of our energy to plan follow-on funding. Normally we do not dive very deep into operations, but develop reporting practices and metrics, and how the firm is managed by these metrics. We do not draw a strict line between strategic and operative work, however." (Firm C)*

An interesting take from the interviews on operational support was the sprint approach used by Firm E, where particular problems are worked on together for a defined time, after which the VC could stay in the background and let the team execute. Another variation of sprints is to use short periods where the team works independently, and feedback is given frequently. Similar approach is used by Firm F. This helps VCs and their portfolio firms to apply "fail fast" principle in experimental projects. Regardless of being ready to go operative if needed, the common tone among my sample VCs is that there should be clear roles between management and owners in the longer run.

> *"We can be hands-on in first steps but not that much in longer term. That is, short sprints to tackle certain problems." (Firm F)*

> "*In operative work it has to be as clear as possible what we are doing and why. There are usually several different opinions shaking the process so we must actively support the firm to tailor their approach according to the prevailing market situation. We are not only there to bring money, but to be a business partner as well.*" *(Firm A, D)*

> *"We usually hold the chairmanship of the board and steer the action through board work, trying to bring in models and thoughts to help the firm develop its processes. We are active because strong basis has to be created for the business in early-stage firms. Even though we are active, the underlying thought is to keep the roles clear, and board and operative management separated. Sometimes we bring a board member in from our network of trusted people." (Firm B)*

"The team should show genuine respect to the VC for giving its time to help their firm perform. This is not always a "given" when working with ambitious entrepreneurs that have strong views on developing the firm." (Firm D)

In my sample, key operational resources that VCs provide to portfolio firms seem to be recruiting and legal support. One larger VC reported they have specialized personnel to help portfolio firms with their recruiting needs. Another interviewee noted that during the venture's first steps basically all money goes into recruiting new team members.

"*The earlier we go in, the smaller the teams likely are, and the more operative help is often needed. I use my personal contacts to professional recruiters and help the firms throughout the process.*" *(Firm B)*

"We are active in recruiting support and react very fast in this area. We take advantage of our good network and outside recruiters." (Firm G)

"*We make sure that the firm has access to certain know-how. At start the money goes almost solely in recruiting, and the teams normally understand what recruiting needs the firm has. Arranging for introductions between firms, headhunters and potential clients is a centric value add from our part.*" *(Firm C, D)*

"We discuss what kind of skills are needed in the firm, and look at our network with this in mind." (Firm F)

As for legal support, VCs help to prevent their firms from "giving out" too much internally created value to larger business partners and offer support

in negotiatons and other contracting steps. VCs conduct comprehensive business and legal due diligence processes before investment to mitigate information asymmetry in these areas, and to detect improvement items.

> "*IP-related loopholes must be detected and protected early to retain the value with the firm.*" *(Firm E)*

Finally, I find strong consensus that access to additional funding on more optimal terms is the single greatest value-added resource that VCs can provide to portfolio firms. Given the level of growth ambitions of typical venture firms, the availability of significant external financing is a necessity.

> *"Our board role is more important when new financing rounds are on the table, because in such matters we usually have the best know-how and create much value by helping the firm to raise more money on better terms. We act in the interest of all shareholders in these dealings." (Firm B, C)*

> *"We often let our rights bend to streamline follow-on funding. Our advantage is that we can make a call to top-name international VC and introduce the firm." (Firm E)*

4.2 Control role

4.2.1 General

Key question in monitoring portfolio firms is by what means the VC obtains sufficient information to assess whether any action is needed. Portfolio firms' reporting systems might be insufficient at the time of the VC investment, which increases monitoring costs. The sample VCs require

regular reporting from their firms, and support them in building and improving reporting systems.

Five out of seven sample VCs (A, B, C, D, G) name board as primary channel of influence and source of information in portfolio firms. Importantly, some statements on the matter can be interpreted as referring to "steady-state" conditions where the ventures do not need specific attention. Most interviewees report taking at least one board seat or observer seat. Board observers are not necessarily official board members but have the right to participate in board meetings and have full access to the same board materials and information as official board members. Firm D member noted that in many cases mere observer seat can be sufficient for the VC to get relevant information from the venture.

> *"Board is the main control device for us. We can have two initial seats and an observer seat for team training."*
> *(Firm A, D, F)*

> *"We require an observer seat at least, but always take a seat when available to stay informed and secure our interest."*
> *(Firm G)*

> *"There are three ways to get information: board, quartal reporting and forecasts, and written reports. We get the board meeting minutes regardless of being in board or not. In addition, we arrange shareholder meetings, which are not AGMs, to get a view on where we are." (Firm A, D)*

> *"The premise is that portfolio firms abide by good governance. We do monthly checks with board. Reporting systems must be put to work." (Firm B)*

> *"We do not have any general monitoring dashboard. Budgets and forecasts are used for the purpose." (Firm F)*

Only one interviewee (Firm E) presented relatively strong critique to board work in managing venture firms. His point is that, even though the board was a main channel to influence the firm, for "true ventures" it might be too sophisticated governance mechanism in relation to the firm's situation, and distract the venture from its real business issues. He elaborates that growingly formal board work in emerging firms easily leads to inflexibility and bureaucracy, which is not the way to work in venture business.

> *We usually do not take board seats (though they would be guaranteed for us) or focus influence through board. It is not very efficient in venture structure, and formality does not enable learning to us. Deep enough, regular contact is enough for us to avoid surprises. After all, board is not good way for us to address frontline matters." (Firm E)*

One key finding in my sample is that VCs do not want to create unnecessary reporting burden for their firms, but help to build the foundation for financial reporting system as it will be a crucial factor in later stages. As one interviewee put it, without proper reporting system the firm would be *uninvestable* for most investors that participate in financing rounds of more matured firms. Also, the requirements from LPs might steer the information VCs need to obtain from ventures. In some firms, VCs might face serious work in developing reporting to sufficient level.

> *"We do not want the firm to build any reporting systems just for our needs because that would cause extra work. We let the firm to develop reporting on the basis that "this information is important for stakeholders". If we perceive shortage in this regard, we challenge the management about it." (Firm D)*

“We prioritize a lot. Best firms get "manager time" easier. I think many investors cause extra work and do not see things from the entrepreneur’s side.” (Firm E)

“ Most reporting pressure comes from the LP side.” (Firm E, F)

“The quality of reporting has a great influence on how qualified the firm is for follow-on funding. We need to have the right metrics to be communicated to new investors, and it has surprisingly large effect on valuation, though it is not everything.” (Firm C)

At first, reporting systems are mostly satisfactory or weak. We have been able to do major improvements so far, but there is a lot of work to do. We try to create standard reporting model to be employed across our portfolio and with future investments as well.” (Firm G)

Some portfolio firms might do very experimental business or are still on product development stage, which means that they might want to collect very different information compared to more established firms. Importantly, in emerging firms reporting might not focus on traditional reports such as income statements or balance sheets, and is rather aligned to serve firm-specific objectives.

“Transparency issues might arise when reporting concerns something complex, like product readiness for markets or product development pipelines. There can be various milestones, decision points, and audits related to the given object that easily add complexity to reporting on them.” (Firm B)

"We want to make monthly performance evaluation cycle work out in our firms. The earlier the firm's stage, the less meaning we see in P/L statement and balance sheet in reporting. In early stages it is often much more important to measure success in product development steps, customer acquisition, or order intake, for example." (Firm B)

Informal, non-contractible controls were seen important across the sample VCs. Phone calls, chat applications, and informal meetings were referred to as most popular means to support formal channels, and many VCs set forth that they enjoy such interactions the most because they are key to stay on the pulse of portfolio firms, build trust, and maintain open communication. They see that the value is in creating a sense for the entrepreneur that she can be open and ask for help if needed. Also, there were mentions that most teams acknowledge the benefits of asking an experienced VC about what their firm should report. Overall, the main message seems to be that VCs do not really care what the channel is as long as the communication is open regardless of the matter.

"*When I drive a car, I just call to our CEOs and chat about things in an informal manner. These discussions are often very valuable. Around 80 % of our CEOs are open about what is going on, and 20 % not so. In my opinion, the success of these informal interactions is built already at the time of investment when the trust game is opened.*" *(Firm D)*

There is also a sort of respect aspect. That is, whether founders value the VC being there for them. This is something firms should consider whenever making material decisions. They should ask themselves should the VC know about it.

Likely yes if they believe we can bring value in that particular matter." (Firm D)

Finally, provided that there are lots of unknowns in the environments where portfolio firms operate, the available information can be very limited. As such, VCs need to adapt their information needs.

> *"We do want information but have to accept that there might be very little available. In this sense it is hard to demand something that the team can not deliver. In venture capital this likely pertains both the history and future. It has to be put into perspective what kind of information is available at time." (Firm A)*

4.2.2 VC view on contracts

Contracts are relevant for VCs' control role as they are used to allocate rights concerning specified matters. The sample VCs report using relatively standard venture contracts with minor firm-specific modifications. Setting contracts with venture teams reportedly happen without friction even though pre-existing contracts were wiped out. Several sample VCs tell that current shareholder contracts in portfolio firms are materially replaced with their own models, which indicates inflexibility to some extent on the VC's part. Only Firm F indicated that they would join the current agreement with small changes if it is otherwise acceptable. Consistent with prior literature on VC contracts, by insisting to replace the current contracts of the firm, the VC can avoid bargaining with the team and be sure that certain terms prevail across all portfolio firms.

> *"When we come in, possible prior shareholder agreements are wiped out and replaced with new ones, which we negotiate*

with the founders. The main content covers committing the team, general-level objectives, veto rights for AGM and board decisions, and exit terms. The contract is built to support stakeholder alignment." (Firm B, D)

"The contract model could be defined as "venture-standard". Maybe nine out of ten teams accept the contracts in their original form. Very colored term structures are mainly gone. In past times there was less capital available, and the founders' bargaining power could be weak." (Firm C)

Veto rights in contracts serve as protections for VCs. Importantly, they enable the VC to exercise de facto control by preventing an action that is under such veto.

"We have veto rights on the sale of the firm and changes in key personnel, for example. They work as safety clauses so that we could react to misuse or problems. Our vetos are stricter regarding decisions that must be approved by the AGM, whereas our vetos are lighter regarding decisions that the board can make based on the Company Law." (Firm A)

"When money is injected into firm, veto rights basically secure that the money will not be spent on something completely else than it was supposed to." (Firm B)

Basic terms concerning changes in ownership structure, pro-rata rights, team commitment, and exit rights are seen as key contract components. There can be several funding rounds during the life of the venture, so the investment might dilute over time. VCs account for it by including strong pro-rata rights in contracts, which enable them to invest more in subsequent rounds. This finding is consistent with Gompers et al. (2020)

suggesting that pro-rata rights are among terms about which VCs are most inflexible. Importantly, further rounds can allow VCs to reduce their role and influence, which they might do as long as they retain sufficient stake in the firm.

> *"As the firm matures, our strategy might shift towards being something like "enjoy the ride" because at that point there is usually more investors on board and our say on the next steps might have diluted. In any case, from our perspective it is very important that we retain ability to invest heavily more in our best firms." (Firm A, C)*

Even though clear, observable vetos were not in place, VCs expect their firms know when to get approval on material moves.

> *"We are not out there to change the firm, but the firm will not be changed without our approval." (Firm A)*

> *"Vetos are there to guide what entrepreneurs need to discuss with us before doing." (Firm E)*

> *"Our approval is needed for any changes in management, though these are typically initiated from our side as the team may have a biased view as to when professional manager should be brought in." (Firm D)*

The sample VCs do not see contract-related formal control as that evident in practice because contracts are not invoked on a light basis. They widely agreed that in VC relationships contracts work primarily as background frames that define basic terms related to financial and governance relationships. One take was simply that firms are not managed by enforcing contracts. Prior literature suggests that entrepreneurs with strong track-

record in building firms could retain more ex-post control. My evidence suggests that this might well be true, but in typical venture cases the entrepreneur likely has no money or experience, so their bargaining position is weak. In addition, she can be biased in assessing how and by whom the venture should be managed.

> *"Founders can be prone to know better what they need, where we may need to intervene. We like to ask the founder about her own position for years to come, and whether she is ready to change role at some point." (Firm G)*

> *"We constantly assess founder readiness to give lead to professional managers." (Firm F)*

Firm B member does not recall a single case in long VC career where veto rights were exercised. Firm D adds that that if vetos are ever needed, large mistakes have already happened in relationship with the portfolio firm.

> *"If vetos start to concern, we have failed in cooperation at some point earlier. If the firm is open with us, there is no need for vetos. In addition, it is sad if we perceive that the firm does not want to take advantage of our experience." (Firm D)*

> *"Further, if we would ever need to resort to some specific contract term and say "this is how we will do, because the contract enables us to do it, then we as a firm would be in real trouble. In an ideal situation the contract will be checked next time when discussing about exit." (Firm D)*

My findings support the idea that the control VCs exercise in portfolio firms is related to contracts, but not limited to them. Importantly, VCs can use contracts to make their influence much greater than what mere ownership

share would suggest. Firm C confirms that contractually their position is structured so as to the formal ownership share does not matter. However, Firm A notes that there are matters where minority ownership sets limit to actions.

> *"If we are lead investors in a round, we have significant influence though we do not seek nominal voting power. It must be recalled that we are a minority owner, which limits our actions compared to private equity operators, for example." (Firm A)*

4.2.3 Contingencies

State-contingencies typically refer to contractual terms that give rights to the party in specific states or circumstances. In practice, the question is often about the VC's means to intervene if the portfolio firm is not performing or there are disagreements between the stakeholders. Thus, the objective of this section is to provide insight what VCs do when circumstances change.

The VCs' answers underline that everyone wants to reach a good outcome regardless of the problem, and parties can not expect that a contract would be fair to everyone in any situation. There was very little variation between views on dealing with anything that constant uncertainty "throws at them and the team". Open, respectful, and proactive discussion to reach mutual understanding seems to be the only reasonable means to solve for any issues in portfolio firms. Contracts should only set the big lines of the processes whereby the parties can work towards shared goals. Although parties were able to force decisions by voting or contractual means, such actions are considered extremely rare and unlikely, because it could cause great harm to the relationship between investors and entrepreneurs.

"Contracts only set the startpoint, it is hard to write them so that they would work for everyone's best interest in every situation." (Firm E)

"There is no other option than to find the solution through discussion. I do not remember on how many boards I have been over ten years time and there has not been a single time that required voting. It would be the last resort to go behind bureaucracy. Mutual state of will has to be found." (Firm A, C)

Means to deal with failure are critical due to the experimental nature of venture business. Generally, the sample VCs seem to tolerate failures very well and they speak of encouragement over hard means. Firm A states that VCs should not punish firms for bad performance as it easily reduces the will to take risks. I asked the interviewees whether they hold contractual means to gain more control in portfolio firm. Most of them supposed that terms that allow the VC more control in the firm after certain events are not popular in Finnish VC field at all.

"These issues are answered by effective board work, founders are not to be "punished" through loss of control if the performance is weak." (Firm A, C)

"There should be a clear business plan in every firm, which is not a contract. Of course, we have a shared target to execute that plan. If it does not work out, we must sit down together, identify the root reasons, and draw the best way forward." (Firm B, F, G)

"Out of some 70 firms, one or two business plans have worked out as initially planned." (Firm A)

Several interviewees see that business objectives do not belong to contracts as the uncertainty is so high and no one can see the future. Due to close cooperation with portfolio firms, poor periods should not really come as a surprise for the VC, which eases addressing problems together.

> *"In VC world, business risks are something we can not properly address through contracts. We could not ask anyone to guarantee what is going to happen in the future." (Firm B, C)*

> *"Agile methods work in environments with lots of open questions and unknowns." (Firm E)*

According to VCs, if there are overly fixed milestones set, they can distract the team's attention from core tasks that are required to effectively manage the venture.

> *"Contracts do not necessarily include specific milestones. I know cases where milestones are connected to the terms of convertible securities, but we want to avoid such practices because they likely lead to sub-optimization as the team runs blindly after some milestones. Then it is the tail wagging the dog." (Firm D)*

> *"We do not use performance milestones. Knowing that few firms meet their targets, the process is rather experimental." (Firm F)*

Only Firm G reported having used a term whereby the investor had the right to immediately initiate an exit process if the milestone is not met,

though he added that such terms have otherwise been very exceptional, and perhaps useful only in situations where the firm's value is solely based on extremely high growth.

The VC's power to initiate changes in management is a common topic when discussing milestones and contingencies. My interviewees reported that such changes should not be the purpose itself when joining the firm, given the investment is ultimately made in the team and their capability. However, they say to be ready to act whenever manager change seems to be necessary to streamline the firm, and emphasize that disagreeing on the direction of the firm is completely different problem than losing trust. The interviewees' accounts can be interpreted as meaning that they would rather change the key person than initiate a formal process to solve a dispute, which results in better outcome for both parties.

> *"We have had to make manager changes in about 40 % of our firms." (Firm D)*
>
> *"Manager change initiatives tend to come from the investors, for example the entrepreneur may not see by himself when it would be better to bring in a professional manager. Changes in management can not be the purpose itself, however." (Firm D, G)*
>
> *"Our experience is that the parties are well aware of the contract contents and mechanisms. Rarely have I witnessed actual breaches of contract, though leaver situations are different because it is basically impossible to force a person to stay, so the leaver terms trigger and we follow contracts in such events. It is like a trust or no trust situation." (Firm C)*

It might be an excellent strategy for the VC to invest in teams it considers as having a good eye at picking businesses. However, it is very different thing to succeed in that picked business. This can be one explanation for prior findings that changes in management initiated by VCs are business as usual. In such cases, VCs' main motive presumably is to simply replace certain team members with people that are more competent in execution.

My observations about contingencies are to some extent conflicting with prior findings on how popular the terms on state-contingent shifts of control are in VC relationships. As for setting milestones, the VCs seem to acknowledge their risk of distracting focus from things that are more relevant for the venture. Such distractions can cause unobservable and indirect costs that impact the firm's value creation, as suggested by Aguilera et al. (2008). The view does not imply that goals should be set with low ambition in venture firms, however. Finally, it should be noted that preparation to uncertain future with contingency terms is not limited to mere *performance* milestones, but basically any events on the venture's path, such as financing rounds and exit options. It seems that the sample VCs are comfortable as long as they have veto rights in certain future states, and ability to invest more in consequent rounds.

4.2.4 Contribution to incentives

All of my sample VCs report that incentives should be built so that the portfolio firms are able to retain the key persons and that good incentive structures serve as a tool for risk management as well. Compensation structures based on ownership risk (equity, options) are firmly in place and there are little reasons for exceptions. The interviewees emphasize that the team members must hold large ownership and embrace the idea that the greatest reward would come from selling equity rather than raising salary.

"Founders need to hold large stakes before and after our investment. We see compensation packages as the primary risk management tool because they commit the most important: the team. A specific attention item is the founders' positioning in relation to each other in terms of compensation." (Firm B)

"We optimize between salary cost and equity upside. Cash bonuses can be used in connection with some goals." (Firm E)

"We aim to agree on option packages or other share-based incentives at the time of entry. Options are quite popular in Finland as they are relatively tax-effective, for example. Option holders are also parties in contracts even though they did not own any shares yet at the time." (Firm A, F)

Time vesting is a major compensation principle used in VC-backed firms. Basically, it means that significant portion of the team member's compensation becomes available to her after working with the venture for certain period. Share-based arrangements such as options can be used for time vesting so as to the options can be exercised after X years in the firm, for example.

"Basic option terms define that after being 3-5 years in the house, you can subscribe to a certain amount of options. Options are suitable also if they can be exercised in exit." (Firm B)

"Vesting is centric for maintaining entrepreneurial spirit. It is actually a no-brainer because usually the whole team splits if it splits. In our ventures standard option pool is 10 %, no matter who gets 2 % and who gets 3 %." (Firm E)

Recalling that VCs provide their firms with support in recruiting, they help to build the compensation structure so that new hires can be effectively participated in it. The sample VCs emphasize that incentive planning should indeed focus on *new* team members as the founders can be expected to hold sufficient equity.

> *"It is clear that there have to be tools in addition to salary to ensure commitment. We have pre-defined guidelines according to which new team members are committed. Usually, the founders make a proposal to the board, and these get rejected only rarely as long as they are sensible." (Firm A)*
> *"It is actually a key problem in many ventures that people who have joined later do not carry enough equity. We help to solve for such situations." (Firm F)*

> *"New hires are preferred with options, which are basically delayed investing in the firm and bring their holders under the shareholder agreement." (Firm C)*

Leaver terms define what happens to the team member's equity holdings in the firm if she decides to leave the firm. In theory, such terms are intended to make it expensive for the member to leave the firm, though it can be problematic in practice if the member does not perceive that the venture would succeed so that her stake would become very valuable.

> *"Leaver terms are a standard in the field. Good leaver can retain some of his shares, whereas bad leavers may be forced to give their shares back to the firm. These mechanisms are strictly written, especially how they trigger. Member's leave is kind of impossible to stop, so it is very clear when the term triggers." (Firm C, D)*

“Leaver terms are important because if the entrepreneur leaves, nothing is left for the investor. The premise is that a leaver is a good leaver” (Firm E)

According to VC accounts, controls related to compensation can be efficient if performance needs improvement.

“Especially during hard times restructuring of the incentive package to more entrepreneur-friendly direction can lead to great results as it is a sort of wake up call. It might be helpful if founders are "shaken" a bit if things move bad.” (Firm C)

I did not find accurate evidence that VCs would see the team’s prior experience as a heavy factor in incentive planning. VCs report to look compensation matters in each firm case by case, covering also possible special features that may not occur in typical “fresh out of garage” ventures. These findings are to some extent inconsistent with prior literature suggesting that experienced entrepreneurs with critical skills or track-records might receive less performance-sensitive compensation packages. However, similar to whether the entrepreneur could retain more operational control after VC investment, one explanation can be lack of money and experience. On the other hand, the VCs seem to be open for compensation proposals from the team as long as they are sensible.

4.3 Other observations

Before the exit discussion, I asked the interviewees to share thoughts on ESG, which arguably is among the timeliest topics in the industry. All seven VCs in my sample reported to actively promote ESG matters in portfolio firms, but seem to recognize that weightings on letters might vary depending on the case. For example, E and S can be in relatively fair state

whereas G needs improvements if there is little transparency in the firm or its team could benefit from better inclusion. General ESG training seems to be the main tool in supporting portfolio firms to implement the framework.

> *"We provide help to integrate ESG as a part of ongoing business. Today's entrepreneurs have pretty good understanding of these matters." (Firm A)*

> *"At the time of investment, we should go through the roles of all key parties, the board, CEO, management team and so on. This is part of normal process but also works as education on good governance." (Firm B)*

> *"We send our firms yearly surveys on ESG matters and bring them up in informal meetings." (Firm D)*

ESG is relevant for venture market participants because it steers the use of institutional money. For example, certain Finnish organizations may receive funds from the European Union to promote transition to sustainable energy in Finland. Such organizations (potential LPs) can then choose to allocate some of those funds to be invested with VCs that presumably know the best firms working on sustainable energy solutions. If the LPs follow certain responsibility criteria, they probably expect the same from the VC when capital commitments are given, which in turn leads VCs to help implementing ESG in portfolio firms. Therefore, it makes sense that the sample VCs tell most of the reporting pressure comes from the LPs that want to ensure their investments meet the given criteria.

> *"Actually, ESG pressure comes mainly from the LPs, and I would decribe it as "if you want to make a good investment, these things just have to be there".*
> *(Firm B, D, E)*

Finally, the trend of responsibility is likely to continue strong across investment industry, and being negligent about it could lead to increasing cost of capital.

> *"Earlier ESG was a "nice to have", but nowadays it is rather a "must have". Few years ago they were just letters that needed to be there." (Firm D)*
>
> *"We expect the significance of ESG to grow in coming years." (Firm F)*
>
> *"Entrepreneurs' premise is to do the right thing while solving for broader problems. We believe that in five years ESG is business as usual." (Firm B, E)*

4.4 Exit discussion

Exit is the primary source of return for VCs as most cash flows generated by the venture are invested in growth. As a result, it is reasonable that exit planning is a key component in VCs' investment process, and terms related to exit are precisely defined in contracts. On average, entrepreneurs understand that VCs are temporary owners, and exit is inevitable at some point in the future. Thus, preparations for it are conducted before the entry and through the investment period. The VCs report using very standard exit terms, and general objective seems to be that exit is a win to all shareholders instead of certain parties collecting the prize through strict liquidation preferences.

"We expect founders asking money from us to know that we are a VC and must get out eventually, so exit plans are discussed on very early stage." (Firm F)

"We only make money by selling firms, so it is in our interest that all parties share the same time horizon. We strive to maximize the value of the firm so we could get the big prize at the time of sale, and all stakeholders will benefit. We strive to build sustainable firms, but we have to exit at some point." (Firm A)

"It is 1x for money put in regardless of the investor, and the rest is shared on pro rata basis. We try to avoid investor-specific liquidation preferences and complicated share class structures. When we gain a lot of good, there is enough for everyone. Simplicity above all, we strive for equality." (Firm D)

Drag-along clauses are standard components in contracts to protect the VC from hold-up problems and ensure that the whole firm can be sold. The interviewees note that there might also be terms related to timeline and valuation, for example, that must be met to unlock drag-alongs. Drag-along enables the investor to force other shareholders to sell their stake on the same terms. However, one key observation from exit discussion is that even though exit terms were precisely defined in contracts, they can be extremely difficult to enforce in practice. To condense the interviewees takes on the matter, it is quite impossible to sell the firm over its team.

"There are often attached terms that define the time period after which drag-alongs can be enforced and possibly threshold for minimum valuation for the firm." (Firm C)

"Drag-along terms are probably the strictest on paper, yet in real life their literal enforcement is rare. I do not recall seeing any forced exits. The thing is, if the buyer can see that the team members are reluctant to sell, then very likely there is not going to be a deal because no one wants to buy a firm where the team is not "in"." (Firm B)

"Liquidation preferences are quite probable pain points, where we might need to come down a lot." (Firm G)

"The ownership stake does not always tell who gets what in liquidation." (Firm A)

"At the end of the day, the team holds the aces in the sale process. Even though drag-alongs were in place, overrunning the team is not wise. As a result, our true power to force selling is weak regardless of what the contract says." (Firm D, E)

Terms on certain timelines or valuation thresholds can evoke thoughts that they are in place to protect the entrepreneur from situations where the VC would sell the firm too early or for too low price. On the other hand, Firm E challenged the conception that sale is most likely initiated by the VC.

"Generally, it is very optimistic to expect exit in under seven years. Early exits are possible, but then it is usually an industrial buyer merging the business on its own." (Firm C)

"Some exit terms might be there to tackle speculative situations, such as when the VC would sell the firm to someone at "too low price". Then the terms can allow the other owners

to buy the VC's shares at the same price it would pay to outside party." (Firm B)

"Mostly it is the entrepreneur who just gets tired and wants to sell too cheap rather than a VC coming in and selling too cheap. It is a tough job to be an entrepreneur." (Firm E)

Typical contracts also stipulate that the team shall stay with the firm for a defined period after the VC exit. Significant change in ownership could be a problematic point of discontinuity, but the interviewees reported that teams take such terms relatively well. In addition, situations where the new owner would be somehow unwanted were seen very unlikely.

"Entrepreneurs understand well why there are terms that require them to stay after the exit as it is their skill and passion the buyer is essentially buying. We cannot see a scenario where an unwanted buyer would be serious to buy the firm." (Firm D)

On what makes a great exit, the interviewees accounts pointed out a range of variables that have to fall in place and recall that it is very optimistic to expect early exit. In rare cases early exits happen, but then the firm is most likely acquired by larger industrial buyer. Such exit path is natural when the parties belong to the same value chain, but it should be recalled that if a firm retains its independence, it has very different incentives to develop its business. For this reason, it may be wiser for an industrial buyer to start the partnership by only acquiring a minority share.

"Existing business relationship between the target firm and the buyer is often a strong advantage as there is no need to push the value proposition because the buyer already understands where the value is." (Firm E)

"When big market is found, there is good room for growth after the exit as well, which makes pricing multiples more reasonable for the acquiring party." (Firm C)

"First of all, we focus on building good firms with the teams. That is because good firms get bought, poor firms you need to sell." (Firm D)

5 Summary

5.1 Conclusions and discussion

I started from the premise derived from prior literature that VCs are active owners who have two roles in portfolio firms: value-added and control. Value-added actions are strongly related to the VC's equity incentives as their purpose is to raise the probability for value-maximizing exit. Control actions are based on contracts, but not necessarily limited to them as there is evidence that investors can use various non-contractible controls with firms. Importantly, contracts serve as a tool for the VC to facilitate intervention in portfolio firms, which enables the VC to accept more risk as it can more effectively protect its interest in the venture, and thus has stronger incentives to engage in value-added actions. As a result, control role is critical for the VC to succeed in value-added role.

I interviewed Finland-based VCs about the resources they provide to portfolio firms and how they see their control role, covering topics such as general governance, contracts, contingencies, and incentives. In connection with the mentioned themes, I explored the channels through which VC influence takes place. The portfolio firm board is a key channel of influence, but in emerging ventures board can be seen a sort of discussion forum for cooperative problem solving rather than an institution for sophisticated corporate procedures. Importantly, board is a key channel to conduct both value-adding and control actions, but it is not necessarily a *favored* one. As one of the interviewees sees it, board may not be the right place to address "front line" issues and many ventures simply are not yet in the stage where board is relevant for governance purposes. All VCs in my sample do not require a board seat, which supports the view that influence largely happens outside actual board meetings.

As for value-added resources, recruiting and legal matters were most highlighted as key operational areas where VCs provide support. For recruiting support, VC actions typically include arranging introductions between firms and executives as well as using contacts in professional networks. Recruiting often demands the most money in early steps of the venture, so it is reasonable to provide support to ensure the recruitments succeed. In legal matters, VCs see the most important support points in protecting intellectual property rights and negotiating necessary agreements with suppliers and clients, for example. Finally, access to additional funding can be considered the most important value-added factor that VCs can enable for performing portfolio firms. That is, VCs can contribute to getting funding on better terms and arrange financing rounds with new investors to whom the firms might not get access otherwise. However, access to funding as a key value-added factor can be seen to some extent conflicting with the popular idea that the value of a modern VC is something other than money.

Control role is based on contracts that are made at the inception of a VC relationship, and their primary purpose is to allocate rights and define economic effects between the parties. Majority of the VCs in my sample replace pre-existing shareholder agreements with their own models. Though minor modifications are done case by case, they do not see their contracts diverge from “industry standards”. For example, vetos, pro-rata rights, leaver terms, and exit rights form a basic structure. Importantly, contracts can be built so that the VC’s nominal ownership share is irrelevant. That is, the VC’s influence can be significant regardless of its position as a minority owner. However, in practice the VCs see contracts as background frames that should have little meaning in managing the venture. Even though long veto lists were included, the items under vetos could rather be described as actions that must be approved by the VC. After all, the VCs do not see that in a working relationship there would ever be need for literal enforcement of vetos.

Monitoring of ventures may focus on very different information than traditional financial statements provide. For example, weight can be given to product development pipeline status or client acquisition metrics. The VCs seem to mostly refrain from putting unnecessary reporting burden on their firms as they believe it easily distracts the firm from real business issues. The same seems to apply on setting overly fixed performance milestones as it could lead to sub-optimization. Remarkably, state-contingency terms seem to have little relevance in the sample, at least in terms of performance monitoring. The result is interesting because performance-related contingency terms have a significant position in prior VC literature. Lack of contingencies does not imply that performance is not expected, but the VCs share the view that teams should not be punished for taking risk by loss of control if problems occur. The VCs acknowledge the high uncertainty around the venture, which should be addressed by proactive cooperation with the team instead of reallocation of control. They are quite unanimous that there is no other way than open discussion until mutual understanding is reached. Finally, in trust issues it is often better for both parties that the team member is changed.

With respect to incentive design, the VCs promote share-based models with time vesting to retain the key persons in the firm. The VCs help to build such packages to ensure that team members hold significant equity stakes and new members are included in option pools or other arrangements that create owner incentives. They speak of committing new hires as more important challenge than founder incentives, which should be a “given”. This is reasonable since the new hire’s talent can be critical for the firm, but it can also be easier for her to leave the firm because of her lighter ownership compared to the founders. Time vesting is necessary mechanism for controlling the investor’s risk because in emerging firms there would be nothing left if the team decides to leave.

I also discussed with VCs about ESG, which can be expected to grow its impact across the investment industry going forward. The VCs report that their LPs put pressure for implementing ESG in portfolios, but emphasize that for today's entrepreneurs ESG concepts are mostly a premise, not exceptions that are implemented selectively. Teams reportedly understand that ESG matters have to be in place to make a good investment, and VCs support their firms to adopt ESG so that in a few years it would become business as usual.

Exit is typically the only source of VC return, and the winners are expected to enable the whole fund to meet its return target. VCs need to be able to invest more in anticipated winners, which happens by exercising pro-rata rights when new money is raised for the firm through new financing rounds. The VCs highlight that it is optimistic to wait early exit and expect entrepreneurs to have the right attitude on the matter. Ultimately, the team holds significant power when it comes to selling the firm. Even though the contract allowed to force liquidation, in practice it can be impossible to overrun the team because no one would buy a firm whose team is opposing the deal.

Finally, venture *ecosystems* become increasingly important in finding and developing the next winners. A point can be made that in best ecosystems participants take advantage of networks to efficiently allocate talent and capital, and the VCs that gain strong reputation through success are very important contributors to future projects. That is, such VC can invest in a new venture now, but also enable additional financing in the future as other VCs are willing to invest with it because they trust in the initial VC's judgment. Therefore, the VC's role as a "door opener" is actually two-sided. First, it likely expands potential financing options for the venture. Second, it helps other VCs to find investable projects by reducing their sense of uncertainty about the venture. This VC role is to some extent self-evident, but it can actually be much more significant in countries where venture

ecosystems are less developed compared to environments such as Silicon Valley. As ecosystems continue to develop globally, the topic could attract research interest.

5.2 Limitations and further research

As presented in the introduction chapter, I do not draw strict lines for which characteristics make a VC. The only criteria I used are that they invest in minority stakes in emerging, entrepreneurial firms and describe themselves as active owners. I acknowledge that “emerging” can be used for early-stage firms as well as firms that are taking major development steps. Therefore, the sample selection of this study does not fully follow certain classification of VCs, such as division into seed-stage, growth equity, expansion capital, or based on their target industries. The portfolio firm’s life cycle stage likely affects on how active the VC is with it, which can limit the strength of my findings. In addition, there are significant differences in the sample VCs’ own resources like assets under management or team size.

Finnish VC firms form a relatively small fraction of the international VC industry, so the used sample only represents a small share of the Nordics ecosystem. However, it should be noted that Finland is currently very popular target for international venture investments, and local market participants can benefit from getting exposed to international venture managing practices. In other words, VCs likely learn from each other, which reduces the likelihood that the ways Finnish VCs operate would be greatly different from other VCs in the market. Certain VCs interviewed for this thesis represent high-profile names in Finnish VC industry, and have broad connections to international VC network. As a result, it is reasonable to believe that these VCs have gathered knowledge on what practices are conventional among international players, and thus have relatively good judgment when it comes to VCs’ methods as owners.

There is an argument that the Finnish VC industry is somewhat homogenic in that knowledge and capital are concentrated to a relatively small network of entrepreneurs, investors, and advisors. However, renowned domestic VC names have growingly sought for change to this "thinness" in the Finnish ecosystem by sharing strong views in media against impeding immigration policies, for example, that might seriously damage Finland's attractiveness in the eyes of foreign professionals. Future research could explore the next generation of VCs that increasingly consists of people who have launched a start-up by themselves and thus do not look things straightforwardly from the "banker perspective". It would be interesting to study more how former founders' perspective on active ownership compares to that of a mere financier.

A likely future projection is that multinationality in Finnish start-up ecosystem will see a great expansion, and its implications on venture governance are to be seen. Emerging firms taking a "born global" approach from the beginning might need to team up with a VC much earlier than firms whose business is more like a hobby for founders. VCs push firms towards higher professionalism as they go through funding rounds. It is common that VCs form syndicates and select one investor to represent the whole syndicate in the portfolio firm board, for example. One interesting avenue for future research would be to study how the presence of a syndicate affects managing the venture compared to the setting when there is only a single VC.

Finally, there are signs of an interesting phenomenon in international VC field that is said to be largely fueled by fierce competition. Media sources mainly from the US suggest that even top VC names have ended up competing of the best teams, so founding teams get more and more say on relationship terms. Such development implies that the more money the VC can give, and the less it would intervene, the easier it would get the deal.

Competitive VCs could basically throw money at any founder they can find that they think could be successful. We can only wonder what implications it would have on governance when money is no longer considered as scarce means for a venture firm. These cases could be worth a closer study in the future, especially how the post-investment cooperation works.

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Appendices

Appendice A: Figures

Figure 1: General VC structure (by Da Rin et al., 2013)
Figure 2: Term flexibility as reported by VCs (by Gompers et al., 2020)

Table 1: Characteristics of VC firms

Appendice B: Interview checklist

1. What are your main criteria for investment selection?

2. What is your target ownership share and how is it determined?

3. What resources do you provide to portfolio firms?

4. How do you influence the following matters:

   a) Board work and management in general
   b) Contracts
   c) Monitoring and reporting
   d) Incentive design
   e) Other points (ESG etc.)

5. Exit path