



**BUSINESS
SCHOOL**

**ACCESS TO FINANCE OF SMES: YOUNG GROWTH
ORIENTED COMPANIES AND COMPANY TRANSFERS**

BELSPO SMEPEFI PROJECT REPORT TA/00/41

ACCESS TO FINANCE OF SMES: YOUNG GROWTH ORIENTED COMPANIES AND COMPANY TRANSFERS



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Acknowledgements

We gratefully acknowledge the excellent research assistance of

- Thomas Bonesire, Université de Liège
- David Devigne, Vlerick Business School
- Anantha Divakaruni, Vlerick Business School
- Jonas Van Hove, Ghent University

Our research strongly benefited from the critical input of the members of our guidance committee:

- Edouard Abeloos, Belgian Venturing Association
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- Guy Geldhof, Vesalius Biocapital
- Patrick Jordens, Agentschap Ondernemen
- Fabrice Lobet, Bureau van Dijk and Université Libre de Bruxelles
- Cornelius Mueller, EVCA
- Anne-Mie Ooghe, Febelfin
- Nathalie Sierens, Participatiemaatschappij Vlaanderen
- Arjen van Witteloostuijn, Universiteit Antwerpen
- Olivier Witmeur, Solvay Business School

Academic members of the guidance committee:

- Massimo Colombo, Polimi, Milano
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All opinions expressed in this document are nevertheless the sole responsibility of the authors.

1. Executive Summary

The SMEPEFI project, funded by the Belgian Science Policy (BELSPO, Research project TA/00/41) studies the access to finance of small and medium enterprises (SMEs), mainly by exploiting existing databases as stipulated in the call.

In working out policy measures to increase the access to finance of SMEs, the Belgian government is confronted with a range of international, national and regional data which are very often isolated pieces of information, lacking an integrated perspective or failing to take into account the specific characteristics of the Belgian institutional context. The main goal of this study is to provide valuable input for policy makers in their aim to increase the access to finance of SMEs. The core focus of the project is on two central processes: the financing of young innovative, growth-oriented enterprises and the financing of business transfers. More specifically, the objectives are twofold. We aim to increase insight into (1) *how companies are financed* in their initial growth phase and when transferred, and (2) *how these financing strategies impact their further development*. Further, we recognise that financial resources are critical to the development of firms, but that not all types of financing are equal. Hence, we examine the impact of differences between financing sources and financiers on the development of young SMEs.

A third stream of research deals with the entrepreneur as the driving force of venture development. Understanding how founders make decisions will enrich current research on venture growth. We investigate how entrepreneurs self-identify their role and experience passion through exercising that role, and how this impacts the development of their ventures. A greater understanding of founder's identities may contribute to the development of more fine-grained and relevant policies to promote growth.

Our key findings can be summarized as:

1. Access to finance for entrepreneurial companies

Based upon a theoretical optimization model, we show that easier access to external funding (including venture capital and bank loans) improves the desirability of business projects for entrepreneurs, as the optimization of project funding reduces the entrepreneur's hurdle rate. Thus, a larger supply of external funds enhances firm founding rates, especially if the cost of funding is kept at reasonable levels.

Nevertheless, funding is not equally available to entrepreneurial firms in different countries. We show empirically that better shareholder protection rights in a country increase the probability of raising external equity financing and allow firms to raise larger amounts of equity financing. Less forgiving personal bankruptcy laws decrease the probability of raising debt financing and limit the amount of debt financing that is raised. VC ownership strengthens the aforementioned relationships.

Not all money is the same, however. Entrepreneurial companies initially backed by domestic venture capital investors exhibit higher growth in the short term compared to companies

backed by cross-border investors. Companies that are initially funded by a syndicate comprising both domestic and cross-border venture capital investors exhibit the highest growth in the long term. Nevertheless, when a portfolio company fails to meet its initial expectations, cross-border venture capital investors terminate their investments more rationally and more quickly, while domestic investors are more patient and forgiving. .

2. Access to finance for business transfers

In financing business transfers, equity sponsors play a crucial role together with banks. In a typical leveraged buyout (LBO), a professional equity sponsor acquires an existing firm (target) by financing a majority of the transaction through debt borrowed from one or more lenders. Equity sponsors are not homogeneous. We empirically show that different sponsor types specialize in particular types of transactions. Financial sponsors (bank and insurance firm affiliates) finance smaller and less risky projects, while diversified sponsors finance larger companies and private sponsors finance riskier companies. Further, risk aversion and bargaining power impact the type of equity sponsor involved in the deal as well as the loan spread granted by the lender. For example, financial sponsors are more willing to invest in higher risk aversion and higher lender bargaining power environments.

We further examine the role of stakeholder relationships in the financing of LBOs. We show that relationship-building with lenders through recurrent interactions allows PE-sponsors to raise more LBO debt on cheaper terms and with fewer covenants. Further, lenders use information acquired from prior interactions with targets to determine the viability of an LBO opportunity and to set appropriate financing terms. Interestingly, these relationship effects were largely rendered insignificant during the period following the 2008 subprime mortgage crisis.

We further show that greater institutional quality in the home country of target-firms leads to cheaper LBO financing. LBO costs increase with greater institutional differences (i.e. difference in overall quality of home-country institutions) between PE-sponsors and target-firms, between PE-sponsors and lenders, and between lenders and target-firms. This negative effect can be mitigated by developing relationships with local partners, which also allow PE-sponsors and lenders to gain familiarity and experience in foreign markets, thereby increasing the flow of cross-border LBO capital across markets.

3. The entrepreneur as driving force of venture development

First, we show that entrepreneurs who belong to a profession identify themselves very much with the values of that profession and develop a professional identity which in itself influences the role they want to play as entrepreneurs. The experience of passion results from acting in line with the expectations of the professional community and is a driver to reach goals that are prevalent in the professional community, such as service orientation towards the client. The results of the current study suggest that an individual can experience intense positive feelings for an activity which is central for the individual's self-meaning. Second, we show that different forms of passion lead to different individual goals, such that *professional* passion leads to service goals and *venture development* passion to financial goals. Third, we show that an orientation to service goals creates different venture outcomes than when an entrepreneur is oriented towards economic goals.

2. Project Rationale

It is widely acknowledged that young growth oriented companies play a key role in the creation of employment and wealth in our modern “knowledge-based” economies (Colombo & Grilli, 2005; Storey & Tether, 1998). For example, it has been argued that worldwide, up to six out of every ten newly-created jobs are created by these companies (OECD, 2010). The “Small Business Act for Europe”, adopted in 2008, reflects Europe’s political will to recognise the central role of dynamic SMEs in Europe. One of its major aims is to promote SMEs’ growth by enabling them to reap opportunities from globalization and from the acceleration of technological change. The EU recognizes that “SMEs still face market failures undermining the conditions in which they operate and compete with other players in areas like finance (especially venture capital), research, innovation and the environment” (Small Business Act for Europe, 2008, p. 3). For example, about 21% of SMEs indicate that accessing the right kind of finance is a problem; finance comes second on the list of their concerns (2007 Observatory of EU SMEs). Hence, the facilitation of SMEs’ access to finance (and in particular to risk capital and mezzanine finance) has been defined as a key area of interest, as well for starting and growing businesses as for transferring businesses. The latter is important, as an estimated 6 million small business owners will retire over the next ten years in Europe. Transferring these businesses successfully might preserve more jobs than those created by new start-ups (Small Business Act for Europe, 2008). Despite the growing academic and political interest in the financing of SMEs, the current state of research does not allow for drawing unequivocal conclusions about the most effective policy measures to be taken to improve access to financing for SMEs.

Negative or insufficient cash flows and lacking entrepreneurs’ own financial resources make external financing crucial to pursue young growth oriented companies’ full potential. Unfortunately, many of these firms fail to realize their potential due to financing constraints, which hamper firm growth and even threaten firm survival (Carpenter & Petersen, 2002; Cooper, Gimeno-Gascon & Woo, 1994). Young growth oriented companies initially need to invest high amounts in intangible assets in order to build a sound and growth oriented company. The low and difficult to assess liquidation value of intangible assets, makes these type of assets unsuitable as collateral to secure bank loans (Manigart, Baeyens and Verschueren, 2002). These assets give rise to large information asymmetries between the entrepreneur and external financiers: it is extremely difficult for external investors to assess the potential of an intangible project. Moreover, these young companies do not have a financial track record which can serve as a benchmark for their future performance (Berger and Udell, 2002). As a result, asymmetric information and agency problems – compounded by the lack of internal cash flows and collateral – explain why these companies experience difficulties in acquiring external financing or why this financing can be prohibitively expensive (Carpenter & Petersen, 2002). The SMEPEFI project therefore strongly focuses on the availability of equity funding for starting, growing and transferring businesses.

Furthermore, we know surprisingly little about what drives the processes that underlie the variance in growth amongst founder-run firms. Research dictates that the decisions

entrepreneurs make in the venture's early years have profound long-lasting implications for performance. How founders make decisions about growth and financing is influenced by their meaningful identities. Does Richard Branson consider himself in the first place to be a passionate marketer or is he passionate about growing and expanding his business? Is James Dyson a passionate designer or a passionate business developer who commercializes his designs? Was Mark Zuckerberg a passionate software developer at Harvard or passionate about founding and growing a business? Each of them is an example of a successful entrepreneur, but it remains unclear to what extent they have a passion for a 'profession' (professional passion hereafter) they exercise or a passion for 'developing the business' (development passion hereafter) and to what extent this passion is a key determinant of their success.

3. Project Execution

In line with our research objectives, the research consists of several phases. Part A focuses on the financing of young, growth oriented companies and its impact on their subsequent development and potential exit. Team Liège developed a theoretical model aimed at optimizing the investment and financing decisions of the entrepreneur when (s)he considers creating or expanding a business project as well as measuring the cost of capital (hurdle rate) of the business project for the entrepreneur. Empirically, the relationships were tested by Team Vlerick using the VICO database,¹ a database containing longitudinal data on 8391 young innovative companies in 7 European countries (including Belgium), which focuses on their financing obtained and on their investors. The database oversampled companies that have received VC, in order to understand how critical this financing alternative is and how important it is in the development of entrepreneurial companies. The VICO database has been enriched with information from VentureXpert, Zephyr and Factiva.

Part B focuses on the financing of buy-outs. Buy-outs are specific types of firm (or business unit) transfers, often initiated by the existing management team, and typically financed with the financial help of private equity (PE) investors. A unique, hand-collected dataset was developed by team Vlerick comprising 5,992 LBO transactions during the period 1986-2012 and spanning 52 countries. Information on LBO deals was obtained primarily from LVENTURE Dealscan and was augmented with data on PE-sponsor and lender characteristics from ThomsonOne. Information on institutional characteristics was sourced from a number of sources including the World Bank, International Monetary Fund, World Governance Indicators and the World Values Survey (WVS) project. In analysing the database, team Vlerick focuses on relationships between PE-sponsors, lenders and target-firms, and the impact of cross-country institutional differences, on the availability and cost of LBO funding. Team Liège analyses which type of equity sponsor is involved in a particular deal, and how this affects the loan spread.

In Part C, Team Ghent focuses on the entrepreneur's identity as professional or as venture developer. Both will impact their strategic decision-making. To test our hypotheses, we required data on passion, goals and individual level and organizational characteristics as control variables. As publicly available databases do not provide the data necessary to examine our propositions, we collected primary data using a survey instrument. We choose the "Registered Nurses" (RNs) engaged in primary home care in Flanders as our population of interest for two reasons. First, scholars have since long defined nursing as a profession. Second, about 60% of the primary care market in Flanders is served by entrepreneurial RN's, who have created their own ventures, while 40% is controlled by incumbents of which typically the medical insurers are main shareholders. This allows for diversity in the population. The survey is based on the extant literature on identity and passion (e.g. Baum, Locke, and Smith (2001) and Murnieks et al. (2014)), complemented with extensive pilot studies including participant observation with five different RNs and interviews with 10 RNs.

¹ Bertoni, F., & Marti Pellón, J., 2011. Financing entrepreneurial ventures in Europe: The VICO dataset. <http://ssrn.com/abstract=1904297>

We surveyed the founders of 468 nursing practices randomly selected from the database of the Flemish Association of Independent Home Nurses, resulting in 212 respondents (45% response rate).

4. Project findings

a. YOUNG COMPANIES

One important source of external capital for young growth oriented companies is VC firms, which are financial market intermediaries, specializing in the management of information asymmetries and high levels of uncertainty (Carpenter and Petersen, 2002; Gompers and Lerner, 2001). This enables them to provide capital to companies that might otherwise have severe difficulties to attract financing (Gompers and Lerner, 2001; Wright and Robbie, 1998). VC firms invest in high-risk companies by purchasing equity or equity-linked minority stakes, aiming for significant capital gains (Gompers and Lerner, 2001). VC investments are hence in essence long-term, illiquid, high-risk, hands-on, privately held, minority equity investments in high-growth-potential companies initiated and managed by professional investors.

Following questions have been addressed in the Belspo SMEPEFI project: (1) how does the availability of funding impacts entrepreneur's investment and financing decisions; (2) how does the type of VC impact the funding the entrepreneurial companies; (3) how do Belgian companies finance their development compared to similar companies in different EU countries; (4) how do national institutions and VC ownership influence external financing decisions in private young growth oriented companies; (5) how do initial VC investors impact the portfolio company's development.

The availability of funding and the entrepreneur's investment and financing decisions: Optimization model²

The optimization model for the entrepreneur works as follows. The entrepreneur has to decide to invest a (large) part of his wealth in the business project (he is limited in his wealth diversification potential) but he has the possibility to invest the remaining part of his wealth in other assets. The entrepreneur has the choice between three possible financing sources for his project: he can use his own funds, he can borrow funds from a bank (debt) and he can attract VC who receives part of the equity. The entrepreneur can combine financing sources. When all decisions have been optimized, our model identifies the business project's cost of capital (hurdle rate) which is the minimum return that should be expected from the business project by the entrepreneur and other investors to make it an economically sound investment.

Our our model shows that obtaining external funds from VC, banks or a combination of both is always better for the entrepreneur than having to finance the business project with his own funds only. In most cases, a combination of bank loans and VC is the optimal financing mode. This highlights the importance of getting access to external funding. Second, our model shows that the optimization of the entrepreneur's investment and financing decisions increases the attractiveness of entrepreneurial projects and will encourage entrepreneurs to start more projects. Third, the optimal entrepreneurial wealth allocation and the optimal project funding depend on the characteristics of the business project (including its size, expected return and risk), the risk aversion of the entrepreneur and the bargaining power of all financiers. Thus, they have to be optimized accordingly.

² Thomas Bonesire and Georges Hübner, 2015. Optimizing portfolio allocation, project financing deals and the cost of capital for the entrepreneur. Working Paper, HEC-University of Liège.

Availability of entrepreneurial funding in Belgium versus Europe³

We empirically compare the financing strategies of Belgian young, technology-oriented companies with similar companies in four other European⁴ countries. We focus on two dimensions of the financing strategies of young growth oriented companies: (1) *how often* is a certain type of finance attracted in a timeframe of five years and (2) *how much* finance is attracted. We differentiate between raising financial debt and external equity. As VC is suitable to finance young growth oriented companies, but not available or requested by all companies (Baeyens, Knockaert and Manigart, 2006), a matched⁵ sample of VC backed and non VC backed companies is used.

The results show that European non-VC backed companies issue proportionally more often debt compared to external equity (55% debt vs. 45% equity), but external equity issues are proportionally more frequent than financial debt issues in European VC-backed companies (45 debt vs. 55% equity). Belgian companies raise less often external financing but if they do, they rely much more often on debt compared to their European counterparts. Further, when Belgian companies raise external finance, the median amounts are smaller than their European peers, both relating to debt and equity issues. Young, Belgian technology-oriented companies hence raise less external finance than their European peers.

The initial VC investor impacts the amount of follow-on financing their portfolio companies are able to raise. Ventures backed by larger VCs raise twice as much equity compared to ventures backed by small VCs, but the latter attract large amounts of financial debt at higher frequencies. Taken together, this results in an average total external issue of €2 million per company when backed by large VCs and €1.5 million per company when backed by small VCs. Next, ventures backed by cross-border VCs raise five times more equity and three times more debt compared to ventures backed by domestic VCs. Third, the probability to attract follow-on investments is smallest with university VCs and largest with government related VCs. Ventures backed by bank VCs raise the largest median amount of debt and equity, followed by companies backed by independent VCs. Ventures backed by university VCs raise the smallest median amount per issue.

National institutions & VC ownership: Explaining cross-country differences⁶

Given the striking disadvantage of Belgian companies in raising finance, we investigate how a country's institutional framework and a venture's governance impacts the financing decisions of innovative companies. As measures of country-specific governance factors, we focus on the quality of law enforcement as a measure of the country's legal system, as a driver of the supply of finance, and the availability of a fresh start for the entrepreneur after a bankruptcy as a measure of the severity of bankruptcy law, as a driver of the demand for

³ Vanacker, T., Seghers, A. and Manigart, S. 2012. Follow-on financing of venture capital backed companies. Chapter X in Douglas J. Cumming (ed.), *Handbook of Entrepreneurial Finance*. Oxford: Oxford University Press, 373-400.

⁴ From here onwards, we will use the term "European companies" to refer to companies from Finland, France, Spain and the UK. All companies are a maximum of 10 years old at inclusion in our sample. The sample timeframe includes both financial boom (1999-2001) and financial bust (2007-2008) periods.

⁵ Non VC backed companies are comparable to the VC backed companies in our sample with respect to industry, country of origin and age.

⁶ Published in Tom Vanacker, Andy Heughebaert and Sophie Manigart, 2014. Institutional Frameworks, Venture Capital and the Financing of European New Technology-Based Firms. *Corporate Governance: An International Review*, 22(3), p.199-215.

finance (Cumming et al., 2010; Bottazzi et al., 2009; Lerner and Schoar, 2005). As company-specific corporate governance factor, we focus on VC ownership.

Results indicate that entrepreneurial companies operating in countries with a better law enforcement or with more forgiving personal bankruptcy laws raise more entrepreneurial finance, including both debt and equity, and have on average a higher debt ratio. VC ownership, as a measure of corporate governance practices at the company level, results in more entrepreneurial finance, in larger amounts of equity and in lower amounts of debt. The positive relationship between better law enforcement or more forgiving personal bankruptcy laws and entrepreneurial finance decisions becomes stronger when entrepreneurial companies raise VC finance, suggesting that VC ownership and a country's legal system or bankruptcy law play a complementary role in reducing agency problems for investors in entrepreneurial companies.

*VC origin and investment strategies*⁷

As international VCs have a disproportionate positive effect on a venture's fundraising capacity, growth and development, it is important to understand how international investors choose their targets. International VCs use several strategies to alleviate liabilities of foreignness (LOF) (Bell et al., 2012), such as focusing on projects with lower ex-ante information asymmetries or that need less advice which both will decrease information costs (Dai et al., 2012). Second, they may syndicate local partners as this lowers information asymmetries between entrepreneurs and cross-border VCs due to the increased information production by the local investor.

Our results confirm that cross-border VC firms have a lower probability of investing in informationally opaque companies in the Europe. Interestingly, this effect disappears when controlling for co-investor characteristics. More specifically, cross-border VC have a higher probability to invest with local investors, with larger investment syndicates and with more experienced investors. Cross-border VC are more strict when assessing their co-investors when evaluating seed stage companies compared to non-seed stage companies. The potential contribution of co-investors to the company - measured as their experience and local presence - increases the probability of a cross-border VC to match with seed stage companies. Finally, investing through a local branch as opposed to from a foreign head office allows foreign VCs to exhibit the same investment behaviour as domestic VCs. In order to attract international VC to a country, it is hence a prerequisite to have a healthy local VC industry.

*VC origin & venture development*⁸

Prior research provides both advantages and disadvantages of obtaining cross-border VC. For instance, foreign VC investors legitimate companies in foreign markets (Mäkelä and Maula, 2005), which is expected to benefit the international sales of ventures. However, the

⁷ This study is part of the doctoral dissertation of David Devigne, "International venture capital investors and their portfolio companies in Europe", Ghent University, 2013

⁸ Published as David Devigne, Tom Vanacker, Sophie Manigart and Ine Paeleman, 2013. The role of domestic and cross-border venture capital investors in the growth of portfolio companies. *Small Business Economics*, 40(3):553-573.

commitment of cross-border VCs is expected to be lower compared to domestic VCs, especially when performance falls short of early expectations. (Mäkelä and Maula, 2005). This may reduce the amount of assistance provided by cross-border investors to their ventures, which may hamper their development. The goal of this study is to investigate the economic consequences of getting cross-border VC compared to domestic VC.

Using longitudinal Random Coefficient Modelling, we show that high-tech ventures backed solely by cross-border VCs grow initially at a lower rate than ventures backed solely by domestic VCs. In later years, ventures backed by cross-border VC investors exhibit higher growth rates. Ventures backed by a syndicate of domestic and cross-border VCs experienced stronger early and later growth than other VC-backed ventures. Alternatively, ventures initially backed solely by domestic VCs, which later added an international VC to the syndicate, performed equally well as those having international VC since the first investment round. Hence, a mix of domestic and cross-border VCs, either from the outset or later on, leads to ventures that outperform all other combinations. An explanation is that domestic VCs provide close counselling to ventures, while international VCs provide internationalization skills and networks.

VC origin & termination of underperforming ventures⁹

Not all ventures are successful. When ventures underperform, VCs face a liquidation dilemma: they may either further finance the venture to keep the option of improvement or terminate it, which entails certain losses (Tversky and Kahneman, 1992). While prior research has shown that VC firms in general escalate their commitment and keep investing in underperforming ventures (Guler, 2007), we show that escalation is more prevalent when domestic VCs invest, compared to cross-border and branch VCs. The smaller geographical and cultural distances domestic VC firms face result in higher emotional and social embeddedness (Mäkelä and Maula, 2005; Guiso et al., 2008; Bottazzi et al., 2012). Local branches of international VCs are shielded from escalation of commitment because investment decisions are typically made by a mixed investment committee, comprised of both local and international managers. Domestic VCs may hence benefit from mimicking the behaviour of cross-border investors.

b. BUSINESS TRANSFERS

Globally, LBOs have emerged as an important mechanism of value creation, allowing owners and investors of low-growth companies to extract value through appropriate restructuring initiatives. In the following, we will address following questions studied in the Belspo SMEPEFI project:

(1) what type of target companies (and in which circumstances: risk aversion, bargaining power) have their business transfer (buy-out) financed by different types of equity sponsors (private equity investors)? (2) What is the impact of risk aversion and bargaining power on the buy-out deal's loan spread? (3) How do relationships between PE investors, lenders and the target company impact the loan spread and amount? (4) How do national institutions impact the buy-out loan spread and amount?

⁹ David Devigne, Sophie Manigart and Mike Wright. Distressed portfolio company exit and cross-border venture capital investors. Under review, Journal of Business Venturing.

Type of equity sponsors (investors) in buy-out deals^{10, 11}

The objective of this empirical study is to determine how the type of equity sponsor involved in a buyout deal depends on the characteristics of the buying entrepreneur (manager), the target company and the lenders participating in the deal. A common categorization in the literature identifies two types of sponsors: financial sponsors (including bank-affiliated sponsors and insurance firm affiliates) and non-financial sponsors. François and Hübner (2011) propose a more refined categorization of sponsors based on the opportunity costs of equity and debt funding, and hereby differentiate between private equity and diversified sponsors. Private equity sponsors have a higher cost of equity than other sponsors, while financial sponsors have more favorable funding costs than other sponsors.

We highlight several findings. First, private equity sponsors finance on average the riskiest deals, financial sponsors finance least risky deals and diversified sponsors finance middle-risk deals. Second, diversified sponsors finance on average the largest deals, financial sponsors finance the smallest deals and private equity sponsors finance middle-sized deals. Third, when risk aversion is larger, the buyout deal has a higher probability to be financed by financial sponsors. Fourth, when the reputation of the lender is larger, the deal has a lower probability to be sponsored by a private equity sponsor but has a higher probability to be financed by a financial sponsor. Since financial sponsors tend to finance small companies with low risk, these companies seem to be the preferred targets of reputational lenders. We conclude that each type of equity sponsor specializes in companies with particular characteristics. Moreover, risk aversion and lender reputation also have an impact on the type of equity sponsor involved in buyout deals.

Impact of risk aversion and bargaining power on the loan spread in buy-out deals

As the previous study highlighted that risk aversion and lender reputation impacts the type of buyout deals, we further studied whether this also impacts the price of the loans, as measured by the loan spread. We show, counterintuitively, that in periods of high risk aversion, the spread margins of LBO deals are lower. A possible explanation may be that only the least risky buyout deals are financed when risk aversion is high. If fewer deals are supported by sponsors, the competition between lenders may also increase, reducing the lenders' bargaining power and resulting in lower loan rates.

When the activity in the LBO market increases and competition between sponsors and between lenders decreases, the spread margin decreases. Sponsors have more bargaining power and obtain better credit conditions. Lenders have more bargaining power and select least risky deals. In contrary, in periods of low LBO market activity (high competition between sponsors and between lenders), sponsors have less bargaining power and have to accept

¹⁰ Pascal François and Georges Hübner, 2011. A Portfolio Approach to Venture Capital Financing. Working paper, HEC Montréal, HEC-University of Liège.

¹¹ Thomas Bonesire and Georges Hübner, 2015. The types of private equity sponsors and their investments in leveraged buy-outs: in what types of target companies do they specialize and what is the impact of bargaining power and risk aversion? Working Paper, HEC-University of Liège.

higher borrowing rates. Moreover, lenders have less bargaining power and have to accept financing more risky deals resulting in higher lending rates.

When the equity sponsor's or lender's reputation is larger, the spread margin of the LBO deal is lower. Higher reputational equity sponsors are able to use their higher bargaining power in order to obtain lower buyout loan rates. Further, more reputational lenders are involved in least risky deals: their reputation gives them the ability to select the least risky companies.

The role of stakeholder relationships on the cost and terms of buyout funding¹²

We further analyzed the impact of relationships between PE-sponsors, lenders and target-firms on the costs and terms of subsequent LBO financing. Our findings show that relationship-building with lenders through recurrent interactions allows PE-sponsors to raise LBO financing on cheaper and more benevolent terms. Besides lowering the interest rates, stronger relationships also allow PE-sponsors to finance larger LBO transactions with fewer covenant restrictions. We also recognize that PE-sponsors and lenders invest in multiple LBO opportunities and consequently maintain ties and dependencies with many other partners in their respective networks. Differences in dependencies on different partners introduce power-differentials between PE-sponsors and lenders. Our results suggest that LBO debt is costly and difficult to obtain when PE-sponsors are less dependent on their relationship lenders due to information asymmetry and aggravated monitoring costs. However, lenders offer concessions in the form of cheaper and flexible loans to dependent PE-sponsors, in order to prevent them from seeking other competitors and ensure steady access to future deal flow.

Our analyses also show that relationships between lenders and target-firms have equally significant effects on LBO financing terms. Lenders use information acquired from prior interactions with target-firms to determine the viability of an LBO opportunity and set appropriate financing terms. Lenders rely less on PE-sponsors and have greater bargaining power depending on the depth of their prior association with target-firms. These relationships were largely rendered insignificant during the period following the 2008 subprime mortgage crisis. Lack of credit availability seem to have driven lenders to minimize their credit exposure and prevent defaults by refusing loans even to well-acquainted borrowers. These concerns were non-existent before 2008 when economic conditions were good and markets were awash with cheaply available credit.

The role of host-country national institutions on cross-border LBO financing costs¹³

While institutions play crucial roles in attracting foreign capital, the heterogeneity in their quality across countries makes it difficult to ascribe LBO activity to any particular institutional dimension. We create a multidimensional index of institutional quality that captures the legal,

¹² Divakaruni, A., Meuleman, M. 2015. The paradox of stakeholder power in leveraged buyout financing: A multiple agency perspective. Working paper, Vlerick Business School

¹³ Divakaruni, A., Meuleman, M. 2015. Navigating uncertain waters: Challenges of multiple institutional differences and agency conflicts in international LBO financing. Working Paper, Vlerick Business School

financial, political and cultural aspects of national institutions that may affect the flow of foreign LBO capital.

We find that greater institutional quality in the home country of target-firms leads to cheaper LBO financing. LBO costs, however, increase with greater institutional differences (i.e. difference in overall quality of home-country institutions) between PE-sponsors and target-firms, between PE-sponsors and lenders, and also between lenders and target-firms. This suggests that cross-country differences in institutional environments act as barriers to learning about local corporate practices, legal procedures and national cultures. PE-sponsors and lenders face high uncertainties and experience difficulties in controlling and monitoring their investments when institutional distance with foreign partners is high. This informational ambiguity and moral hazard can be mitigated by developing relationships with local partners. In other words, conflicts resulting from institutional differences can be mitigated by strong relationships between LBO participants, thereby increasing the flow of cross-border LBO capital across markets.

c. FOUNDERS' IDENTITY

Successful entrepreneurs often have multiple identities through which they experience passion in the roles they perform in their ventures. Considering the importance to understand why entrepreneurs make different choices and the role which recently has been attributed to identity theory to explain those differences (Cardon et al., 2009; Fauchart and Gruber, 2011; Powell and Baker, 2014), there is a need to further understand how social and role identities are formed and how these lead to different goals and venture outcomes. Following questions are studied: (1) Do entrepreneurs who belong to a professional community experience a “professional passion” embedded in their professional identity in addition to their “development passion” based upon their developer identity?, (2) How does professional passion, if present, influence the goals they strive for in their ventures?, and (3) How does professional passion impact venture outcomes such as profitability and growth?

We show that entrepreneurs who belong to a profession identify themselves with the values of that profession, and develop a professional passion that focuses on the expectations and goals of the professional community such as service orientation. Additionally, an entrepreneur can have a ‘developer’ passion by striving for goals deemed to be important for entrepreneurs, such as financial outcomes. We show that both passions can co-exist. Professional passion partially mediate the impact of development passion on the venture outcome: too much focus on service goals comes at the expense of profitability. Nevertheless, there remains a direct and positive impact of professional passion on profitability. This might be explained as entrepreneurs strongly focusing on the service goal achieving high levels of service quality, which in turn enhances their reputation and consequently their financial profitability.

5. Implications

5.1 Entrepreneurs

In order to support entrepreneurial activity in Belgium, entrepreneurs should be guided towards better investment and financing decisions, which will increase entrepreneurial activity. Regarding the investment decisions, entrepreneurs should optimize and diversify their wealth allocation by investing in other financial assets. They will have more own funds available for diversification if they can attract external funds (bank loans, VC) to finance their business project. Considering different financing options, entrepreneurs should realise that VC ownership results into a greater access to both equity and debt. Importantly, entrepreneurs which large cash needs should target large VCs with sufficient cash to invest again later, VCs that are well respected and/or well connected with other (international) VCs who can take over their role at a later moment. Ambitious entrepreneurs should target well respected VCs, and ideally attract both local and international investors. Nevertheless, while international VCs may be especially beneficial for ventures when they perform well, they also terminate investments more easily when ventures do not meet expectations.

Similarly, financing of business transfers (buyouts) is complex and risky. New owners who usually lack sufficient funds partner with private sponsors to obtain the necessary financing. New owners should target equity sponsors which suit the characteristics of their target company:

- Diversified sponsors for large companies with medium risk;
- Private equity firms for risky companies of medium size;
- Financial sponsors (bank or insurance firm affiliates) for small companies with low risk.

Unlike public markets that finance companies through transparent and generic channels, private equity and debt markets employ highly structured and complex contracts to finance business transfers involving private and/or small and medium-sized companies. Equity sponsors and banks play a crucial role as intermediaries in these markets by screening potential buyout opportunities through due diligence and most importantly on the basis of pre-existing relationships with the company, its owners and other important stakeholders. New owners should search for funding from well-connected parties. Strong relationships between PE-sponsors, banks and targets, based on previous interactions, provide better information on the company's prospects, resulting in the provision on cheaper financing for longer durations. Better relationships also facilitate simpler contract design by imposing fewer restrictions on new owners and improve their chances of obtaining additional follow-on financing when required.

Finally, we have shown that strong identities such as the ones developed in professions through professional communities, determine the way in which entrepreneurs identify themselves with the roles they play in the venture, through the passion they develop for the new roles and the goals they strive for. Entrepreneurs should know their identities in order to make better decisions that fit their passion.

5.2 Policy makers

Our findings also have important implications for policy makers. First, the institutional environment, including the rules of law and their enforcement, strongly impacts the availability of financing for both entrepreneurial ventures and business transfers, and this for both equity and debt. A strong legal system that facilitates contract enforcement, protection of property rights and efficient bankruptcy resolution is necessary to improve funding for entrepreneurial ventures and for business transfers. This is especially true if the aim is to attract foreign investors.

VC finance has a strong, positive effect on the supply of finance for entrepreneurial ventures. Policy makers should hence understand that VC is not only important as “investor of last resort”, but also that VC finance will further increase access to finance. Hence, VC finance will not only alleviate financing constraints for ventures directly but also indirectly. Policy makers may therefore make strong efforts to develop an institutional environment that further encourages a strong, local VC and PE industry. For example, governments may create an environment that permits institutional investors to invest in VC and PE funds with limited costs, compared to Luxemburg’s SICAR structure. In this respect, the increased investment restrictions imposed by Basel III (banks) and Solvency II (insurance companies) and the restrictive interpretation thereof in Belgium is extremely worrying.

Our research clearly stresses the importance of large VC firms in the development of growth companies. We therefore advise governments to focus their support to a limited number of large VC firms rather than dispersing their limited resources over multiple smaller VC firms. Multiple small VC firms lead to multiple small investments and hence result in companies which stay relatively small. The relatively large amount of small VC firms in Belgium may be one of the key reasons why Belgian VC backed companies raise less finance compared to their European peers.

Public policy programs that aim to develop a strong local VC and PE industry in order to foster the growth of local companies should recognize that stimulating cross-border investments and the establishment of local branches by foreign investors is beneficial. Stimulating international VC and PE investments not only significantly increases the financial capital available to companies, but also provides them with complementary resources that help them to develop and grow more strongly. In addition, enabling domestic investors to grow internationally will further strengthen the local VC and PE industry. The government should hence develop an action plan to strengthen the ties between local and international VC and PE firms, to stimulate international syndication and to stimulate international VC and PE firms in setting up local branches. The Belgian government could for instance follow the successful example of Israel.

In comparison to established buyout markets in the US and UK, the buyout market in Belgium is yet to realize its full potential. Absence of large local PE-sponsors and limited takeover opportunities are some reasons for this situation. Besides, very few global PE players have a presence in the Belgian PE market. Dominance of the local debt market by three to four major banks combined with higher compliance costs constrains Belgian firms and PE-sponsors from raising external finance. Policy makers are encouraged to create an

investor-friendly business environment through appropriate changes in laws and regulations to address these concerns.

Healthy financial markets benefit from a diverse pool of investors, which target different types of companies. Furthermore, in periods of high risk aversion, equity investors related to banks or insurance companies are more active than others. Hence, in these adverse conditions financial sponsors should be supported and measures should be taken to facilitate their capacity to increase their investment volumes. Since PE-sponsors tend to specialize in specific industries, policy makers should make it easier for local firms to access appropriate PE-sponsors, both for their capital and industry expertise. Steps taken in this direction will also aid in nurturing strong relationships between PE sponsors, banks and firms, which are crucial for the development of a vibrant buyout market in Belgium.

6. Valorisation to practitioners, policy makers and the academic community

A lot of efforts have been made to disseminate the result to practitioners and policy makers. Many of the findings of the project are currently embedded in **teaching** and courses at the bachelor, master, MBA and executive education level. Miguel Meuleman has launched The Entrepreneurial Buyout Platform (Vlerick Business School), which aims to promote acquisitions by individuals. Annually, the “Buy Your Own Company” conference is organized, drawing between 100 and 200 participants. This is followed by an in-depth training for 35 aspiring buyers (Entrepreneurial Buyout Academy).

Following **press releases** have been organized:

<http://www.vlerick.com/en/research-and-faculty/knowledge-items/knowledge/not-all-venture-capital-is-the-same>

<http://www.vlerick.com/nl/research-and-faculty/knowledge-items/knowledge/het-ene-durfskapitaal-is-het-andere-niet>

<http://www.vlerick.com/en/research-and-faculty/knowledge-items/knowledge/family-owned-businesses-are-struggling-to-find-external-finance-to-fund-investment>

<http://www.vlerick.com/en/about-vlerick/news/boundaries-hamper-growing-businesses>

Presentations were given at various practitioners and policy events, including:

- 2014 Workshop “European Commission Business Transfer”
- 2014 Brussels Exchange Forum, presentation on "Institutional Frameworks and SME Access to Finance"
- 2014 BVA Academy, “Overview of the PE/VC landscape in Belgium”.
- 2014 KBC Bolero Crowdfunding Platform launch, "Financieringsmogelijkheden voor entrepreneurial start-ups".
- 25/10/2014, VRT-EEN – De Vrije Markt, Interview on the financing of entrepreneurial companies in Belgium.

Two major **dissemination events** for practitioners and public policy makers were organised. On the 25th of November 2014, the research team organized a first dissemination event on “Who seeks shall find: looking for investors for start-ups and buy-outs in the new financing environment” in cooperation with VOSEKO, the alumni association of the Faculty of Economics and Business Administration at Ghent University. 250 people were present at the event. During the event, Sophie Manigart and Miguel Meuleman presented the results of the SMEPEFI-project, where they focused on the financing opportunities for start-ups and buy-outs, as well as the real impact of the various financing options. Afterwards, the academic results were debated during a panel discussion with entrepreneurs from the field, Wiet Van de Velde (Palletkraft) and Koen Wille (Scierie de Challans), and with financiers Alex Brabers (Gimv) and Philip Wietendaele (ING), moderated by Bart Clarysse. More information on the event can be found via this [link](#)¹⁴; the review can be read [here](#)¹⁵ (both in Dutch).

¹⁴ <http://voseko.be/data/voseko-event-wie-zoekt-die-vindt-op-zoek-naar-investeerdere-voor-start-ups-en-buy-outs-in-het-nieuwe-financieringsklimaat/>

A second dissemination event was organized for financial experts, including bankers, investors, lawyers and M&A advisors on the 29th of January, 2015. The event was organized in cooperation with the Platform for Entrepreneurial Buyouts (PEBO) of the Vlerick Business School. Sophie Manigart and Miguel Meuleman presented the results of the SMEPEFI project to 85 experts in the field, followed by discussions.

Project-related academic publications

Academically, the project enabled one finished Ph.D. and one Ph.D. to be finalized, 6 published papers, 5 additional working papers, 3 book chapters and 1 book.

Bacon, N., Wright, M., Meuleman, M., Scholes, L., 2011. The Impact of Private Equity on Management Practices in European Buyouts: Short-termism and Anglo American Effects. Industrial Relations, forthcoming.

Bacon, N., Wright, M., Ball, R., Meuleman, M., 2013. Private equity, HRM and Employment, Academy of Management Perspectives, 27(1)

Bonesire, T. and Hübner, G. 2015. Optimizing portfolio allocation, project financing deals and the cost of capital for the entrepreneur. Working Paper, HEC-University of Liège.

Bonesire, T. and Hübner, G. 2015. The types of private equity sponsors and their investments in leveraged buy-outs: in what types of target companies do they specialize and what is the impact of bargaining power and risk aversion? Working Paper, HEC-University of Liège.

Clarysse, B., Van Boxstael, A. and Van Hove, J. 2015. Linking Founder Identity, Goals and Performance: the Role of Professional and Development Passion. Academy of Management proceedings (forthcoming).

David Devigne, 2013. International Venture Capital Investors and their Portfolio Companies in Europe. Doctoral dissertation, Ghent University.

Devigne, D. and Manigart, S. 2013. Investment Strategies Of Cross-border Venture Capital Investors. Frontiers of Entrepreneurship Research 2013. Babson Park, MA: Babson College Vol. 33(2), Article 1.

Devigne, D., Manigart, S. and Wright, M. 2015. Distressed portfolio company exit and international venture capital investors. Working paper, Ghent University.

Devigne, D., Vanacker, T., Manigart, S. and Paeleman, I. 2013. The role of domestic and cross-border venture capital investors in the growth of portfolio companies. Small Business Economics, 40(3):553-573.. DOI: 10.1007/s11187-011-9383-y

François, P. and Hübner, G. 2011. A Portfolio Approach to Venture Capital Financing. Working paper, HEC Montréal, HEC-University of Liège.

¹⁵ <http://voseko.be/nieuwsitems/terugblikwiezoektdievindt/>

Manigart, S., Standaert, T. and Vanacker, T. 2015. Seed and Venture Capital. In D. Audretsch, and A. Link (Editors), Elgar Guide to Entrepreneurship. Edgar Elgar, forthcoming.

Manigart, S. and Wright, M. 2013. Reassessing the relationships between private equity investors and their portfolio companies. *Small Business Economics*, 40(3):479-492. DOI: 10.1007/s11187-011-9387-7 (SSCI impact factor: 1.555)

Manigart S. and Wright, M. 2013. The relationship between venture capital and private equity investors and their portfolio companies. *Foundations and Trends in Entrepreneurship Series* (Editors: Zoltan Acs), NOW Publishers (Boston, Delft), 9 (4–5): 365–570..

Vanacker, T., Heughebaert, A. and Manigart, S. 2014. Institutional Frameworks, Venture Capital and the Financing of European New Technology-Based Firms. *Corporate Governance: An International Review*, 22(3).p.199-215.

Vanacker, T., Seghers, A. and Manigart, S. 2012. Follow-on financing of venture capital backed companies. Chapter X in Douglas J. Cumming (ed.), *Handbook of Entrepreneurial Finance*. Oxford: Oxford University Press, 373-400. (ISBN 978-0-19-539159-6)

Vanacker, T. and Manigart, S. 2013. Venture Capital. Chapter 12 in H. Kent Baker and Gregory Filbeck, (eds.), *Alternative Investments – Balancing Opportunity and Risk*. The Kolb Series in Finance, John Wiley & Sons, Inc.

Project-related presentations at academic conferences and workshops

2011

- Babson College Entrepreneurship Research Conference
“A Longitudinal Study on the Impact of the Timing of Cross-Border Venture Capital Entry on Portfolio Company Growth”
- Vico Conference Entrepreneurial Finance: The Real Impact
“Cross-border venture capital and the development of portfolio companies”

2012

- Babson College Entrepreneurship Research Conference
“Distressed portfolio company exit and cross-border venture capital investors: an escalation-of-commitment perspective”
- Midwest Finance Association Conference / Eastern Finance Association Conference
“Institutional frameworks, venture capital and the financing of European new technology-based firms”
- 10th Corporate Finance Day
“Distressed portfolio company exit and cross-border venture capital investors: an escalation-of-commitment perspective”
- Rencontres de Sankt Gall
“The impact of domestic versus cross-border financing on exit probability and timing”
- CGIR Conference on National Governance Bundles
“Institutional frameworks, venture capital and the financing of European new technology-based firms”

2013

- Academy of International Business Conference
“The impact of domestic versus cross-border financing on exit probability and timing”

- Academy of Management Conference
 - “The impact of domestic versus cross-border financing on exit probability and timing”
 - “Matching supply with demand: the impact of VC investor’s origin and portfolio company’s characteristics on investment deal realisation”
 - “Cross-border financial intermediation and domestic acquisitions: the role of host country experience”
- 11th Corporate Finance Day
 - “The impact of domestic versus cross-border financing on exit probability and timing”
 - “Matching supply with demand: the impact of VC investor’s origin and portfolio company’s characteristics on investment deal realisation”
 - “Portfolio optimization and the cost of capital for the entrepreneur”
- Campus for Finance Conference
 - “The role of venture capital in company financial decision making and capital structure”
- EM Lyon / Université de Nice, Research seminar
 - “The impact of domestic versus cross-border financing on exit probability and timing”
- Babson Entrepreneurship Conference
 - “The impact of domestic versus cross-border financing on exit probability and timing”
 - “The Role of Passion and Gender in New Venture Growth”
- IUAP "SOCENT" ("If not for profit, for what? And how?")
 - “Institutional frameworks, venture capital and the financing of European new technology-based firms”
- Skema Business School Research Seminar
 - “Matching supply with demand: the impact of VC investor’s origin and portfolio company’s characteristics on investment deal realisation”

2014

- European Entrepreneurship Colloquium, Brussels, presentation on “Financing entrepreneurial start-ups”
- AllG Conference, Bologna (Italy). Keynote presentation
“The future of entrepreneurial finance”,
- 12th Corporate Finance Day
“The paradox of stakeholder power in leveraged buyout financing: a multiple agency perspective”
- French Finance Association Conference, Ph.D. Workshop
“Portfolio optimization and the cost of capital for the entrepreneur”

2015

- Academy of Management Meeting
 - “The paradox of stakeholder power in leveraged buyout financing: A multiple agency perspective”
 - “Linking Founder Identity, Goals and Performance: the Role of Professional and Development Passion” (selected for Best Paper Award)
- Université Paris I Panthéon-Sorbonne, Research Seminar,
“Portfolio optimization and the cost of capital for the entrepreneur”



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