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Venture capital investment on SME.

Bachelor's Thesis

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TABLE OF CONTENTS

1 INTRODUCTION

1.1 *Background and motivation*

Optimal capital structure for SMEs is probably one of the most contentious issues, if not a puzzle, in finance. Numbers of researchers (Jensen & Meckling 1976; Demsetz 1983; Fama & Jensen 1983; Myers 1984; Barton & Gordon 1988 and Harris & Raviv 1991 among others) have been studying capital structure but unfortunately the main focus has been in the larger companies. Zingales (2000) asserts that, "*empirically, the emphasis on large companies has led us to ignore (or study less than necessary) the rest of the universe: the young and small firms, who do not have access to public markets*". However, comparing venture capitalists affect on SMEs earnings and capital structure have caught less attention in the academic field, especially in the financial crisis.

Venture capital is a notable part of financing among SMEs. First venture capital investments were made just after World War II, since that venture capital investment has been growing. Venture capital investments have suffered a few temporarily downturn during the market crash years in 1974, 1987, 2000 and 2007 in the stock markets. Another remarkable year in venture capital history was year 1958 when US congress passed the Small Business Investment Act which allowed licensing of SMEs. (Venture Capital Investment Firms)

SMEs are significant part of the Finnish economy. SMEs are defined as enterprises which have fewer than 250 employees, and have either an annual turnover not exceeding EUR 50 million, or an annual balance-sheet total not exceeding EUR 43 million (Statistics Finland). In the 2007 99, 7% of the Finnish companies were SMEs and they employed 62% of all private-sector employees. These companies generate 49% of the combined turnover of all the Finnish businesses, and SMEs cover more than 13% of Finland's export revenue. (Federation of Finnish Enterprises)

Starting early 90's SME studies have got more attention in the academic research. Generally, SMEs and entrepreneurial activities are said to be important to economic development (Hamilton and Harper, 1994). Some empirical studies have been made on the capital structure of SMEs with varied and inconsistent results (Chittenden et

al., 1996; Cressy and Olofsson, 1997; Jordan et al., 1998, Michaelas et al., 1999; Esperanc¸a et al., 2003; Hall et al., 2004; Sogorb-Mira, 2005).

Desire to understand more deeply at least one of the many crises in the economy history give urge to this study. In the recent financial crisis money in the all fields; banks, investors, venture capitalists, insurance companies and other big players, searched better and better yields. Rizzi (2009) study private equity markets and found that "*the mega buyout years of 2003 through the first half of 2007 were driven by the same economic forces which underlied the subprime movement. Lulled into a false sense of security by benign economic conditions of the "Great Moderation," investors and institutions increased their risk appetite in search of yield*".

1.2 Objectives

This thesis investigates if venture capital investments affect the development of SMEs positively. The thesis will also view the presence of venture capitalists affect on the capital structure of SMEs and other company determinants in the financial crisis. The research question will be:

- Do venture capitalists have a positive effect on SMEs?
- Can SMEs with venture capitalist survive better in financial crisis than SMEs without venture capitalist?

1.3 Structure of the thesis

The rest of the study has been organized as follow. Capital structure and venture capital theories are introduced in section two to provide background information. The financial crisis is covered in section three. Research data and results are presented in section four. Finally there are conclusions in section five.

2 THEORETICAL BACKGROUND

2.1 Capital structure theories

Capital structure decision for SMEs could be a crucial in the future; bad choices can ruin or destroy the potential of the small firm. Luckily researchers have made many theories about capital structure but there is no universal theory of capital structure and no reason to expect one (Myers 2001).

Cassar and Holmes (2003) stated that generally the theories of the capital structure and financing choices of large firm also apply to SMEs. The biggest difference concerns the conflicts between owners and management. Usually, SMEs tend to have less pronounced separation of ownership and management than larger firms. These theories can be described either in terms of a static tradeoff theory or pecking order theory.

The static tradeoff theory encompasses several aspects, including the exposure of the firm to bankruptcy and agency costs against the tax benefits associated with debt use. In the other hand the pecking order theory suggests that firms have a particular preference order for financing choices used to finance the firm. (Myers 1984)

2.1.1 The Static Tradeoff Theory

Modigliani and Miller stated their famous propositions about optimal capital structure in 1958. In their research their definition of homogenous classes of stock was that in the perfect capital market the price per dollar's value of expected return must be same for all stocks of any given class. Or in any given class the price of every stock must be proportional to its expected return. However, the market value of any company is independent of its capital structure and is given by capitalizing its expected return at the appropriate rate to its class. Basically this can be said that company value is "average cost of capital" which is the ratio of its expected return to the market value of all its securities. Based on these assumptions Modigliani and Miller (1958) announced their proposition I. In perfect market conditions, when there are no taxes, the average cost of capital to any company is completely independent of its capital structure and is equal to the capitalization rate of a pure equity stream of its class. (Modigliani & Miller 1958)

Modigliani and Miller (1958) stated their proposition I that completely leveraged company and completely unleveraged company are same value. According to this capital structure does not matter to company's value. In 1963 Modigliani and Miller fulfilled their proposition I with proposition II. The expected return of equity is higher for a leveraged company than an unleveraged company therefore the risk of equity holders is also higher with leveraged company. However, the value of a stock does not increase in spite of the greater return to one stock. The risk from larger amount of debt is compensated to equity holders by increasing their expected return of equity. Despite of these propositions, in the real world the capital market is not perfect and empirical studies have shown that capital structure has an effect on market value of a company. (Modigliani & Miller 1963)

Myers (1984) stated that a company's optimal debt ratio is often viewed as determined by a tradeoff of the benefits and costs of borrowing, holding the company's investment plans and assets constant. The companies are balancing between tax shields and various costs of bankruptcy and try to find the optimal structure. The companies are supposed to substitute equity for debt, or debt for equity, until they have found the optimum. Figure 1 illustrates that the market value of firm increasing towards the optimum when firm takes more debt. After the optimum, costs of debt become larger than the benefits of the given tax shield. When the firm is crossing the optimum point, the market value of the firm starts to decrease when increasing debt too much. (Myers 1984)

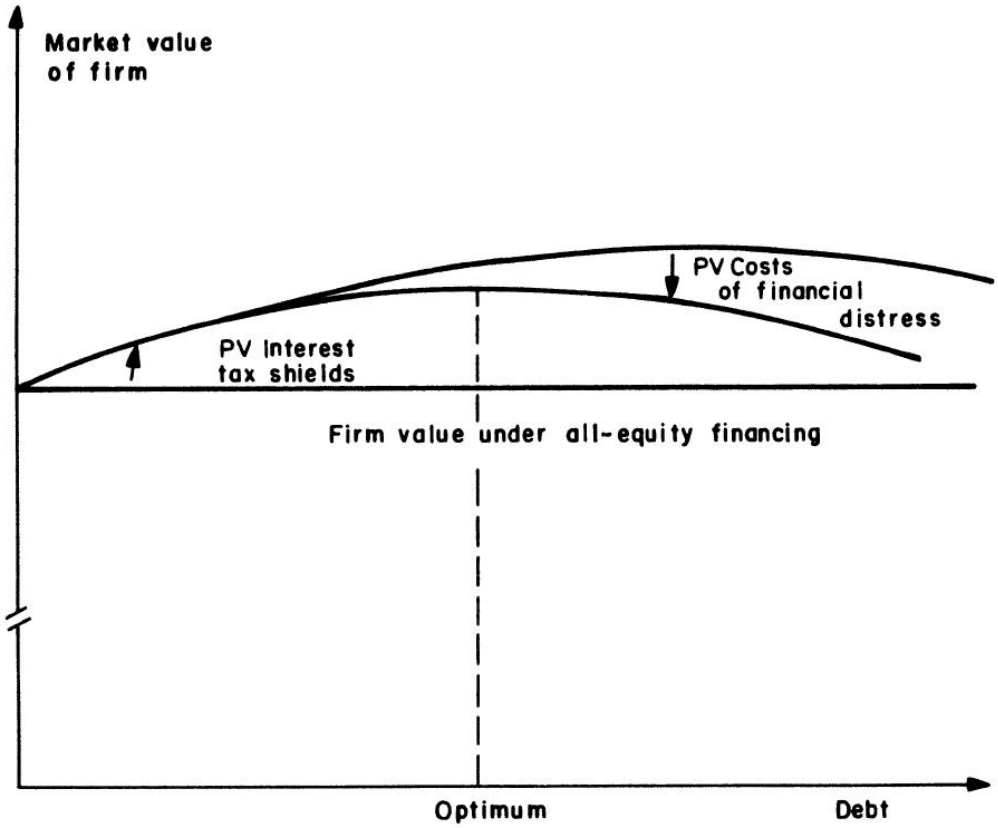


Figure 1. The static-tradeoff theory of capital structure.

Considering more about tax shields, Miller (1977) made an extreme implication from the original MM theory. Miller made interest tax shields so extreme that it could not be explained why not all companies are in deep debt. He described the equilibrium of aggregate supply and demand for corporate debt, in which personal income taxes paid by the marginal investor in corporate debt just to offset the corporate tax saving. However, because the equilibrium only determines aggregates, debt policy should not matter for any single taxpaying company. Unfortunately this only works if we assume that all firms face approximately the same marginal tax rate, but we can reject that immediately. (Miller 1977)

Figure 2 shows the net tax gain from corporate borrowing against the expected realizable tax shield from future deduction of one dollar of interest paid. There are firms which get lot of tax deduction but there are also firms which does not pay any taxes. However, for all of the companies the expected realizable tax shield is positive[1] but small. In the Modigliani and Miller proposition II (MM Theory) any tax-

[1] Regardless of the theory, the slope is upward so it is always a positive.

paying corporation gains by borrowing; the higher the marginal tax rate, the greater the gain. This illustrates the top line in the figure. In Miller's theory, the personal income taxes on interest payments would exactly offset the corporate interest tax shield, provided that the firm pays full statutory tax rate. However, any firm paying a lower rate would see a net loss to corporate borrowing and a net gain to lending. This sets the bottom line. Also compromised theories have been made and those are not that extreme than the other two.[2] (Myers 1984)

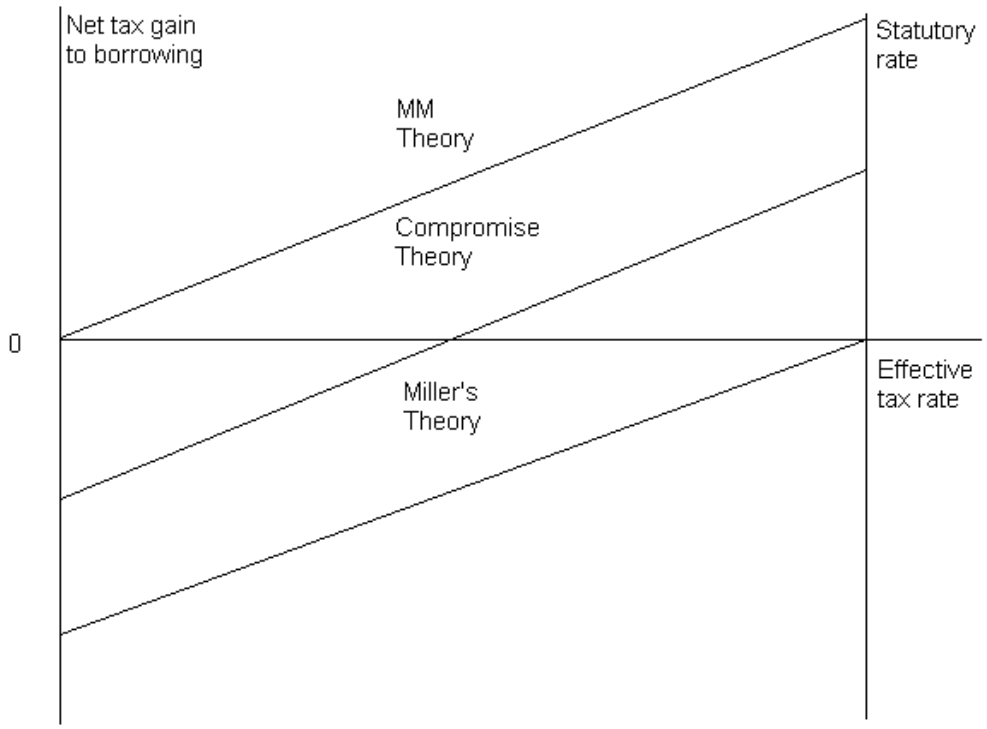


Figure 2. The net tax gain to corporate borrowing.

Solomon (1963) summed one argument as follows: *"one kind of evidence in favor of the traditional position is that companies in the various industry groups appear to use leverage as if there is some optimum range appropriate to each group. While significant intercompany differences in debt ratios exist within each industry, the average usage of leverage by broad industrial groups tends to follow a consistent pattern over time."* Other authors, such as Schwartz and Aronson (1967), have

[2] See compromise theories, advanced by Modigliani and Miller (1966), D'Angelo and Masulis (1980), Modigliani (1982) and Mackie-Mason (1990).

documented evidence of strong industry effects in debt usage, which they interpret as evidence of optimal ratios. Long and Malitz (1985) showed that research and development expenditures relate negatively to leverage ratios as they use those as a proxy for intangible assets. A negative relation between growth opportunities and debt ratios were stated by Smith and Watts (1992).

Bradley et al. (1984) found evidence from earlier theoretical and empirical literature that support the modern balancing tradeoff theory of capital structure. However, Titman and Wessels (1988) found only mixed evidence for the role of the factors predicted by the static tradeoff theory when they used a latent variables approach. Other studies have found more direct evidence that firms adjust their debt ratios toward the optimum. Taggart (1977), Marsh (1982), Jalilvand and Harris (1984) and Auerbach (1985) find mean reversion in debt ratios or evidence that firms appear to adjust toward debt targets.

Optimal capital structure has been studied in various different points of views. The traditional models suggest that firms choose their optimal capital structure by comparing various tax and incentive benefits of debt financing against possible bankruptcy costs. There have also been studies about dynamic models of capital structure (see Fischer et al. 1989; Leland 1994 and 1998) where researchers have found evidence that firms will periodically readjust their capital structures toward a target ratio that reflects the costs and benefits of debt financing found in the static tradeoff models.

Hovakimian et al. (2001) tested the hypothesis that companies tend to move toward a target debt ratio when they either raise new capital or retire or repurchase existing capital. They took into account for the previous studies that companies may change over the time, causing their target ratios to change. Also like previous studies has been noticed[3] that companies consist of both assets in place and growth opportunities and argue that debt ratios are likely to be determined as a function of the changing relative weights of these two components of value. More detail, companies should use relatively more debt to finance assets in place and relatively more equity to finance growth opportunities. (Hovakimian et al. 2001)

[3] See Myers (1977) and Myers and Majluf (1984).

Shyam-Sunder and Myers (1999) argue that pecking order theory provides a better empirical description of capital structures than do traditional tradeoff models. However, Hovakimian et al. (2001) results suggest that, although pecking order considerations affect corporate debt ratios in the short-run, companies tend to make financing choices that move them toward target debt ratios that are consistent with tradeoff models of capital structure choice.

An empirical hypothesis test has been made for 3569 Spanish SMEs over 10-year period. Its findings reveal that also SMEs aim to reach the optimum leverage. However, this takes a little longer time to reach the optimum due to high transaction costs. Also non-debt tax shields, growth opportunities, internal resources, size and age all seem to play important role in determining SME capital structure. (Lopéz-Cracia and Sogorb-Mira 2008)

According to Abor and Biekpe (2009), who investigate SMEs in Sub-Saharan area in Africa, SMEs try to finance their fixed assets with long-term debt and their current assets with short-term debt. This result support the previous empirical studies (see Chittenden et al., 1996; Jordan et al., 1998; Michaelas et al., 1999; Cassar and Holmes, 2003; Hall et al., 2004; Sogorb-Mira, 2005).

Beattie et al. (2006) stated, when they survey UK listed companies that about half of the firms seek to maintain a target debt level, which is consistent with tradeoff theory. They also mentioned that the capital structure decision is a complex multi-dimensional problem.

2.1.2 The Pecking Order Theory

Even though pecking order theory was found in the 80’s there was similar indications in the earlier studies. Donaldson (1961) observed that managers prefer internal financing as the source of new funds. This is consistent with findings what Myers, the developer of the pecking order theory, made. Myers (1984) stated that firms prefer internal finance, firms adapt their dividend policy and if external finance is required, firms issue the safest securities first. He also stated that when outside funds are necessary, companies prefer debt over equity because of lower information costs associated with debt issues.

SMEs often suffer problems linked to asymmetric information, which causes information costs. Usually managers have a better information about the health and prospect of the company than investors does. The pecking order theory predicts a hierarchical order in a company's financial policy. This order is led by the financial sources that are least subject to information costs and at the same time involve less risk. The most preferred funding source is internally generated funds following by low-risk short-term debt and then higher-risk long-term debt. (Donaldson 1961 and Myers and Majluf 1984)

The pecking order theory is derived by assuming a commonality interests between current shareholders and managers (insiders) but asymmetric information and therefore heterogeneous expectation between insiders and potential new investors (outsiders). Due to information asymmetries, outsiders know less about the firms' prospects than the owner-manager. The owner-manager will try to maximize the insiders (also current shareholders) value, not the outsiders' value. If the firm has good investment prospects, the owner-manager will not want to issue new shares because some of the benefits will have to be shared with the new investors. So owner-manager will prefer internally generated funds, followed by debt and the last option would be new shares. But if prospects are poor, the owner-manager will want to issue new shares since it would benefit the current shareholders. (Watson and Wilson 2002)

Cosh and Hughes (1994) and Frank and Goyal (2003) investigate that SMEs natural financial behavior can be described by the pecking order theory. They argue that SMEs are likely affected by typical asymmetric information problems like adverse selection and moral hazard. According to Stiglitz and Weiss (1981) banks respond to both of these problems by collateral because it overcomes the both problems of moral hazard and adverse selection. Diamond (1989) stated that also reputation could help SMEs in these problems.

Cassar and Holmes (2003) argue that owners or managers of SMEs may have constrained skills about financial decision making or financial structures comparing to larger companies. They based this on that managers or owners of SMEs may not normally operate with these day-to-day basis. They find empirical evidence that asset structure, profitability and growth are important influences upon SME financing and

capital structure. They also found weaker evidence for size and risk influencing financing and capital structure choice.

For SME owners some financial options may not be acceptable for personal reasons. Also similar kind of indications were made in the previous studies (see Bird and Juttner, 1976; Holmes and Kent, 1991; Haron and Shanmugan, 1994 and Kotey; 1999) where the focus was more descriptive and explanatory. For example Holmes and Kent (1991) surveyed Australian manufacturers for sources of start-up and additional debt and equity funding and the reasons for their use. Also later Kotey (1999) examined the role of demand side factors such as personal values and financial planning on forms of debt utilized by SMEs in New South Wales, with no consideration of the financial characteristics of respondents.

Fama and French (2002) found that the pecking order theory assumes dividend to be sticky and variation in earnings and investments are dealt with debt. They also found that when controlling investment opportunities more profitable firms have lower debt to assets ratios. As the pecking order model predicts, Fama and French (2001) found that firms which pays dividend tend to have high earnings relative to investment.

Beattie et al. (2006) found that firms are heterogeneous in their capital structure policies. 60% of responding firms argued that they follow a financing hierarchy which is consistent with pecking order theory. They also gather findings, see table 1, from previous studies on capital structure determinants.

Table 1

Findings of prior survey research on capital structure determinants (Beattie et al. 2006).

Author(s)	Year	Respondents	Response Rate	Conclusions Drawn by Author(s)
US Settings				
Donaldson	1961	25 large US corporations	na	Hierarchy of financing sources. **Supports pecking order theory**.
Scott & Johnson	1982	CFO's of 212 of Fortune 1000 firms	21 %	Firms have target leverage ratios and accept the notion of optimal capital structure. **Supports trade-off theory**.
Pinegar & Wilbricht	1989	CFO's of 176 of Fortune 500 firms	35 %	Evidence supports the use of a financing hierarchy. **Supports pecking order theory**.

Norton	1989	CFO's of 98 of Fortune 500 firms	21 %	Some evidence of target ratios, hierarchy of sources. No evidence of a trade-off or asymmetric information or agency costs. **Mixed evidence.**
Graham & Harvey	2001	CFO's of 392 of Fortune 500 firms and 4400 FEI members (4587 population)	9 %	Target debt ratio to maintain financial flexibility. Moderate importance of tax implications, less emphasis on financial distress. Interest cost of debt of moderate importance. **Supports trade-off theory**. Moderate evidence that debt issued when recent profits insufficient and equity issues affected by market valuation. No significant consideration of agency costs/benefits or corporate control. **Supports pecking order theory.**
Settings other than US				
Fawthrop & Terry	1975	54 major UK companies	na	Use of debt ratios to constrain debt limits. Importance of maintaining financial flexibility.
Stonehill et al.	1975	Firms in US, Japan, France, Norway, Holland	na	No debt ratios maintained, take advantage of favorable opportunities to issue debt or equity. **Conflicting both pecking order theory and trade-off theories.**
Allen	1991	48 listed Australian corporations	na	Some evidence on target debt ratios and tax implications of debt. Most concern with maintaining spare debt capacity. Internal funds marginally favored. **Supports pecking order theory.**
Allen	2000	132 Australian, 67 large UK, 53 Japanese	24%, 13%, 10%	UK and Australian firms maintain spare debt capacity to be in a position to seize opportunities or make acquisitions. **Supports pecking order theory**. Not so in Japanese firms.
Bancel & Mittoo	2004	87 firms across 16 European countries	12 %	Financial flexibility/EPS dilution major concerns in debt/equity decisions. Country's legal environment important determinant of debt policies. Costs and benefits trade off determines financing. **Supports trade-off theory.**

Brounen et al.	2004	313 firms across UK, Netherlands, France and Germany	5 %	Financial flexibility major debt determinant, but not driven by asymmetric information. Firm size and shareholder orientation important influences on financing but national influences weak. **Supports trade-off theory but also evidence of pecking order behavior.**

2.1.3 The Agency Theory

An agency relationship is a contract under which one or more persons (the principal(s)) authorize another person (the agent) to accomplish some service on their behalf which involves giving some decision making authority to the agent. If both parties of the relationship are utility maximizers there might be an agency problem because the agent may not act the best interest of the principal. The principal can establish some incentives for the agent or in some situations it can expand the agent resources to guarantee the agent actions. However, it is basically impossible for the principal or the agent at zero costs to make sure that the agent will make optimal decisions on the principal's point of view. (Jensen and Meckling 1976)

According to Van Osnabrugge (2000) when dealing with the potential effects of moral hazard and/or adverse selection, the principal can limit divergences from his own interests by incurring screening costs to reduce the asymmetries of information between the principal and agent.

Jensen and Meckling (1976) identify two types of conflicts. Conflicts between shareholders and managers form because managers do not own 100% of the shares. Consequently they do not capture entire gain from their actions but they still bear all the costs of it. This could usher the managers to consume the firm resources to their own perquisites such as corporate jets or fancy offices. As a result of these actions managers do not maximizes the firm value. This inefficiency is reduced by larger fraction of the firm's equity owned by the manager. (Harris and Raviv 1991)

In Harris and Raviv (1990a) and Stulz (1990) studies, managers and investors disagree over an operating decision. Harris and Raviv assumed that managers want to always continue the firm's current operations even though liquidation would be a better option for investors. On the other hand Stulz presume that managers want to

invest all available funds regardless that it would be better to pay out the cash to investors. In both of these studies it is assumed that these conflicts cannot be solved by contracts. Harris and Raviv posit that debt mitigates the problem by giving investors (debtholders) the option to force liquidation if the cash flow is poor. In Stulz's, like in Jensen (1986), study debt payments reduce free cash flow. Capital structure varies by calculating these benefits and costs of debt. In Harris and Raviv's study investors have control to decide in the bankruptcy situation about the firm liquidation decision and value of the firm. In Stulz's study the cost of debt is that debt payments may more than exhaust "free" cash, reducing the funds available for profitable investments. This comparison of Harris and Raviv and Stulz is summarized in table 2 where the relationship of these two models to Jensen and Meckling (1976) and Jensen (1986) is also shown. (Harris and Raviv 1991)

Table 2

Comparison of agency models based on manager-shareholder conflicts (Harris and Raviv 1991).

Model	**Conflict**	**Benefit of Debt**	**Cost of Debt**
Jensen and Meckling (1976)	Managerial perquisites	Increase managerial ownership	Asset subsitution
Jensen (1986)	Overinvestment	Reduce free cashflow	Unspecified
Harris and Raviv (1990a)	Failure to liquidate	Allows investors option to liquidate	Investigation costs
Stulz (1990)	Overinvestment	Reduce free cashflow	Underinvestment

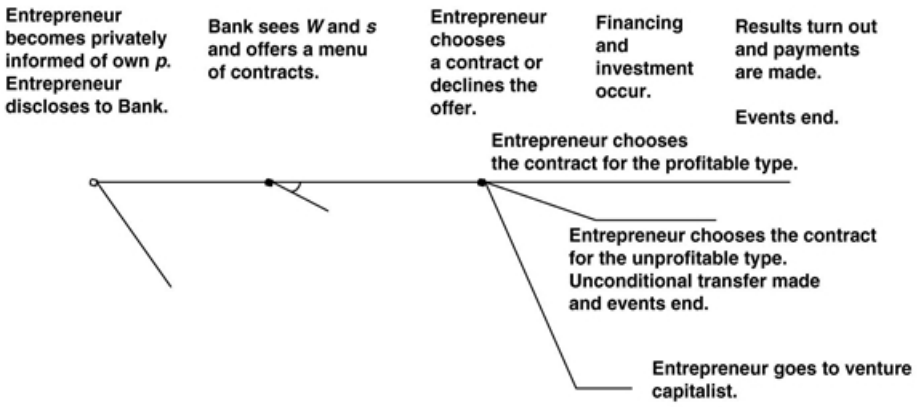
Barnea et al. (1981) pointed out that agency problems are more severe whenever the asymmetric information is greater. The agent may have the capacity and incentive to affect wealth transfers between parties and the corporate contract. Also the agent's partial ownership allows him to consume firm assets while paying less than the sum of the individual costs to the firm's principals. Michaelas et al. (1999) expect agency costs to be higher for SMEs because the owner-manager is likely to put his own interest first especially in the early years when survivor is at stake.

Other type of conflict arises between debt holders and equity holders. Firm have to pay interest to debt holders hence they prefer less risky investments. This is because in the bankruptcy they lose their investment and regardless of the riskiness of firm investments they only receive their interest. All the profits from riskier investments pass to equity holders. Also managers have their influences deciding whether to invest a safer or a riskier project. Considering firm's future, managers also consider their own reputation. Suppose that from the point of view of the manager's reputation there is only success or failure. Thus the manager maximizes probability of success while the shareholders prefer to maximize expected return. If the safer project has a higher probability of success, the manager will choose that even if the other project would be better to shareholders. (Jensen and Meckling 1976 and Harris and Raviv 1991)

Myers (1977) advised for caution of problems that may arise between shareholders and debtholders. He warns that too strict covenants or monitoring devices to debtholders might be obstacle when deciding growth opportunities in the future. Chan (1983) studied the role of venture capitalists in lessening the problem of asymmetric information. He compares an economy with screening agents (venture capitalists) with one without them and shows that introducing them enhances welfare. Holmstrom and Tirole (1997) developed a model of financial intermediaries that can monitor an entrepreneur's effort. In their paper, along with Ueda (2004), they predict that entrepreneurs finance through a venture capitalist if they are short on collateral.

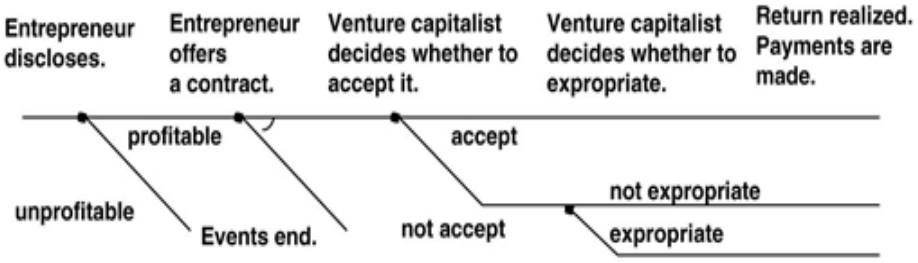
In 2004 Ueda made a sequence of events of how entrepreneur seeks funding. First, as in figure 3, (date 0) the entrepreneur goes to the bank and discloses his project. Then bank seeks to collateral and signals about the future if this project would be profitable. Also bank should consider the information asymmetric what they have between entrepreneur and bank. If they do not succeed with the contract entrepreneur will meet with the venture capitalists (date 1). When entrepreneur have reject the banks offer whether the project was profitable or unprofitable but the offer was not good enough, the entrepreneur negotiate with the venture capitalist. Venture capitalist is often in a better position than banks are because even if the negotiation breaks up, the venture capitalist may still benefit from the entrepreneur's project by expropriating it, where as there is not such an option for the bank. (Ueda 2004)

Figure 3. Date 0 and date 1. *p=profitable, W= collateral, s=signal*



The figure 4 presents the entrepreneur and venture capitalist negotiates and if the project turns out to be unprofitable the negotiation ends. If it is profitable the entrepreneur makes “take it or leave it” offer of a contract to the venture capitalist (date 2). Unlike the negotiation with the bank, there is no asymmetric information and no adverse selection problem. Here it is assumed, for simplicity, that the contract takes a parsimonious form. (Ueda 2004)

Figure 4. Date 2.



2.2 Venture capital financing

Venture capital improves nation’s innovative capacity by making investments early stage businesses that offer high potential but also high risk. There are informal venture capital investors who are wealthy private individuals often known as business angels. There are also official venture capital firms, funds and organizations.

According to Mason and Harrison (2002) business angel and formal venture capitalist differ in a host of ways, including investment experience, resources, governance, investment philosophy and objectives, and the approach to investment decision-

making. They report that formal venture capitalist have more experience and Van Osnabrugge (1998) study that formal venture capitalist have made an average of 23 investments compared with 4 by business angels. Formal venture capitalist make their decisions purely based on the economic consideration, likewise business angels are not responsible to anyone and might make some of the decisions based on other than economic reasons. This is consistent with Wetzel (1981) and Sullivan (1994) who both found that some business angels are willing to make a trade-off between financial and non-financial returns. Business angels are less concerned with financial projections and are less likely to calculate rates of return. They do less detailed due diligence, have fewer meetings with entrepreneurs and are more likely to invest on "gut feeling". Finally formal venture capitalists have more investment capacity than business angels so business angels might not be able finance further rounds if necessary for growth. (Mason and Harrison 2002)

2.2.1 Informal venture capitalist

Informal venture capitalist is defined as private individuals with no family connections who invest a risk capital directly to unquoted firms (Mason and Harrison 2000b). They have gained a major role in the financing of entrepreneurial start-ups and growth firms. Sohl (2003) investigate that informal venture capital market is at least as large as the institutional venture capital market in the USA. While in the UK informal investors have been found to make eight times more investments than institutional investors (Mason and Harrison 2000a). Still the estimates of the market sizes are inconsistent.[4]

Informal investors usually invest to the firms that institutional investors find unattractive because of high uncertainty and small size. One reason is that they invest about 10% of their investment portfolio to unquoted firms which allows them to make more risky investments (Mason and Harrison 1994 & Månsson and Landström 2006).

[4] Formal venture capital operators invest a minimum of € 2.5 million in companies, which leaves a market gap or failure in smaller amounts of equity. Individual business angels invest between 20.000-250.000€. The average amount invested per individual in Europe is 80.000€ and up to 250.000€, depending on the business type and the region. In Europe there are about 125.000 active business angels with total available investments funds € 10-20 billion. In the USA (Freear et al. 1994) there are about 250.000 business angels and total investment funds available around $ 10-20 billion. (EBAN)

Many previous studies[5] have tried to divide and define informal investors into groups for an analysis but there is not any universal definition for that. One definition is that entrepreneurial firms face, in their early development stages, two major resource shortages; the shortage in the financial capital resources (capital cap) and human capital resources (knowledge cap). The capital gap arises because of the reluctance of the financial institutions to provide capital to risky ventures without any previous track record or collateral, while the knowledge gap arises because the entrepreneurial team often lacks the necessary experience and skills (Rasila et al. 2002). The extent of the capital gap and knowledge gap for any particular company depends on the combination of several factors. According to Wright et al. (2004) capital and knowledge gaps are depend on the complexity and the general initial resources requirements of the industry. (Avdeitchikova 2008)

Avdeitchikova (2008) separates the informal investors into four different roles based on the financial, the knowledge or human capital resources. The role is depending on what the firm need. When an individual invests a large amount of financial resources into the firm, without the contribution of any human capital resources, one can state that the investment role is capital-oriented. Alternatively, if investor is actively involved in the activities of the investment object, while the actual financial contribution is low, one can describe the investment role as knowledge-oriented. If the investor contributes a large amount of both financial and human capital resources, the investor takes a classical business angel role. Finally, if the level of contribution is low on both dimensions, it can be suggested the investor takes a micro investor role, reflecting the marginal nature of contribution. This is illustrated in figure 5. (Avdeitchikova 2008)

[5] See previous studies for example; Haar et al. 1988, Freear et al. 1994, Sorheim and Landström 2001.

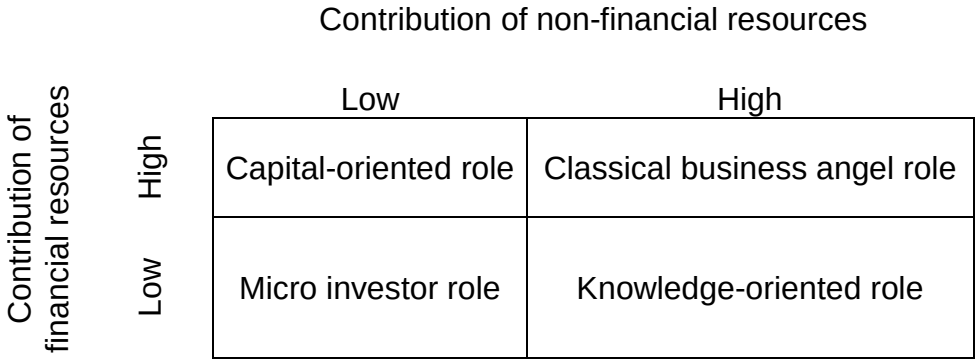


Figure 5. Different investment roles. (Avdeitchikova 2008)

2.2.2 Formal venture capitalist

The formal venture capital financing system involves the stages of raising funds, sourcing investments, making due diligence on potential investments, executing the investments and exiting the investments. The process is described in figure 6 and it starts when the venture capital fund manager seeks the potential investors in order to raise the requisite capital for the fund. The next stage of funding process is to decide the prospect and the targets of the investment. After the investment decision are made, due diligence stage involves a thorough study of the targeted company carried out by the venture capitalists who assess the firms on the basis of the weighted investment criteria. If the due diligence evaluation produces a favorable result, the investment agreements would then be made. The parties make shareholder agreement to establish practical operating rules. Also the monitoring process in every stage is important. Finally, the venture capitalists would consider exit strategies, which is a crucial factor of venture funding. (Wonglimpiyarat 2007)

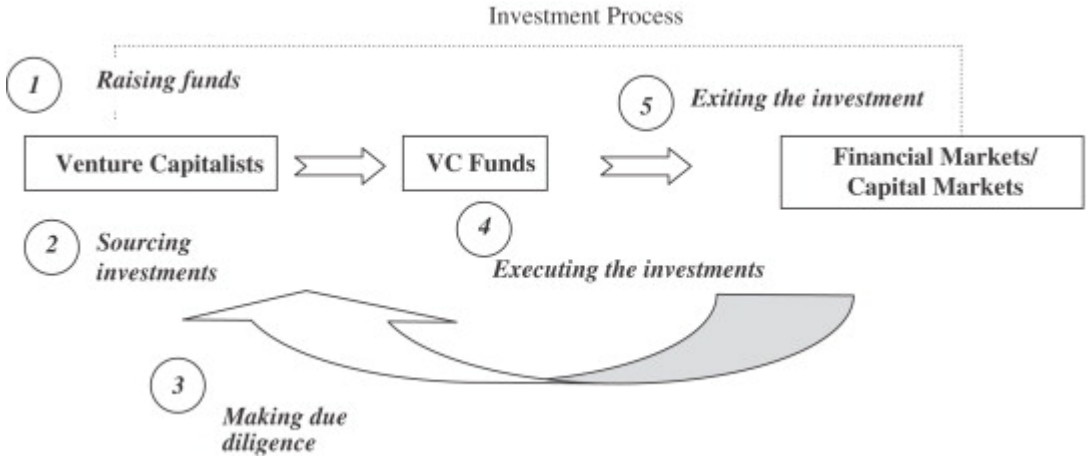


Figure 6. The structure of VC financing system. (Wonglimpiyarat 2007).

An important reason for the presence of equity gap is the fund size of venture capitalists. SMEs equity gap is lack of funding between starting entrepreneur at the beginning but not yet large enough to lure the venture capitalist. This gap is often funded by business angels. Since venture capitalists manage large funds, they need to invest in larger projects if they want to monitor them efficiently. In addition, the fixed costs of project screening and monitoring make it uneconomical for the venture capitalists to make small investment. (Schwienbacher 2007)

Typical venture capitalist or venture capital fund has a certain investment period. They try to plan the investment period up front and the funds are usually closed-end funds. There are number of ways to terminate the financial relationship. Besides liquidation, share repurchases by the founder (buy back) and selling shares to institutional investors (secondary purchase), trade sales and IPOs are the most common ones. (Bascha and Walz 2001)

3 FINANCIAL CRISIS

Mishkin (1992) defines financial crisis as follows: "*A financial crisis is a disruption to financial markets in which adverse selection and moral hazard problems become much worse, so that financial markets are unable to efficiently channel funds to those who have the most productive investment opportunities*". Financial crisis may drive the economy away from the equilibrium with high output to one with low output. The factors causing financial crisis are: 1) increases interest rates, 2) stock markets declines, 3) increases in uncertainty, 4) banks panics, and 5) unanticipated declines in the aggregate price level. (Mishkin 1992)

Figure 7 provides a diagrammatic exposition of the sequence of events that occur during financial crisis. Most of the financial crisis has started by failure of some major financial or non-financial firm causing sharp increasing in interest rates, crashing stock markets and increased uncertainty. While these problems worsen the adverse selection and moral hazard problem, it also make less attractive for lender to lend and led to a declined in investment and aggregate economic activity. Because of worsening economic conditions depositors start to withdraw their funds from the banks scaring that banks might go bankruptcy. The result is a bank panic where interest rates rise and banks financial intermediation decrease causing even worsening of the problems created by adverse selection and moral hazard. Finally insolvent firms go bankruptcy and health firms start to recover and uncertainty starts to decline, stock markets recover and interest rates fall. Also adverse selection and moral hazard problems will shrink and financial markets will start to operate better again and economy will recover. If, however, the crisis leads to a sharp decline in prices the economy might recover slower causing a debt-deflation. (Mishkin 1992)

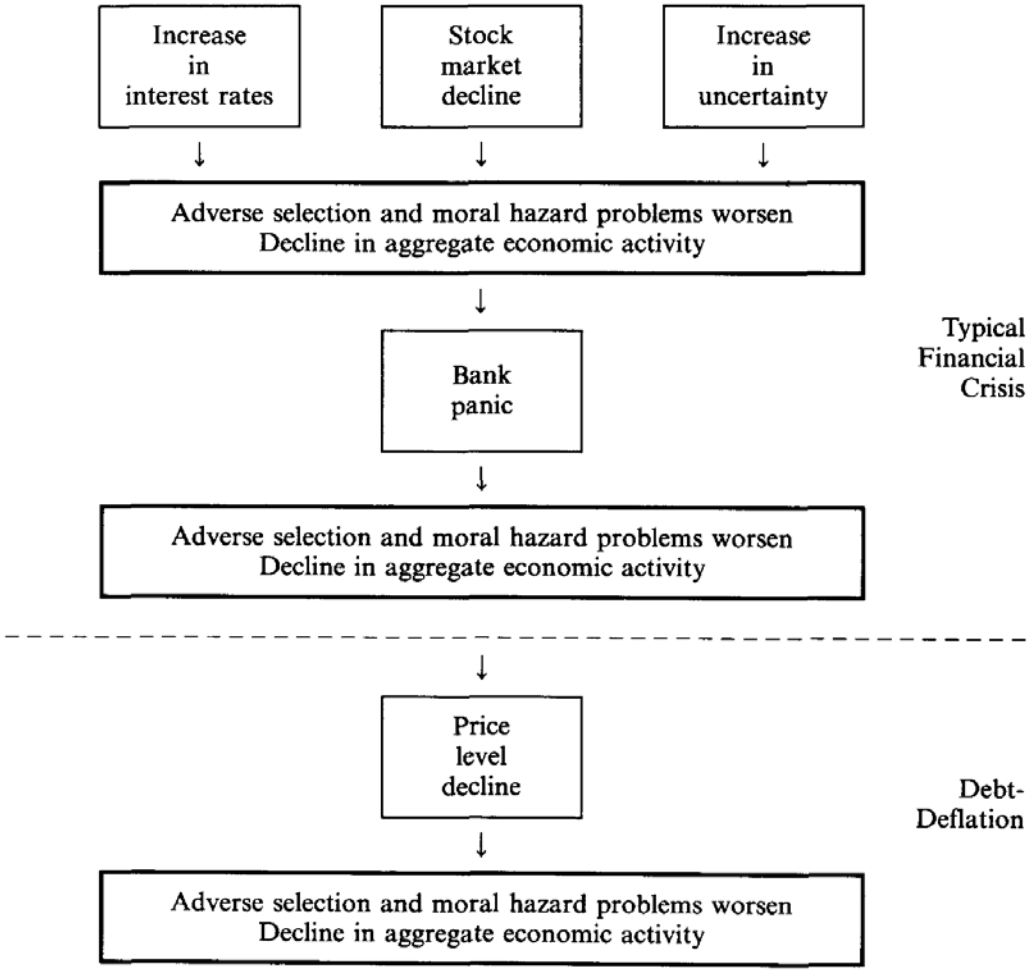


Figure 7. Sequence of events in financial crisis. (Mishkin 1992)

The sequence of events above the dashed line are those that occur in almost all financial crises, while the events below the dashed line occur if a financial crisis develops into a debt-deflation.

According to Reinhart and Rogoff (2009) all major[6] financial crises share three common characteristics. First, asset market collapses are deep and prolonged. Second, there is deep decline in output and employment and third, the government's debts tend to rise.

The recent financial crisis started from securitization in the USA. Subprime mortgages are loans which are admit to customers with weak ability to pay it back and very low or zero down payment. Banks collateral was the house. After granting number of loans, banks wrapped up the loans with credit default swaps and sold it to

[6] Meaning postwar banking crisis in the developed wolrd; Spain 1977, Norway 1987, Finland 1991, Sweden 1991 and Japan 1992)

investors. Those mortgages were designed with a balloon interest payment implying that the mortgage would be refinanced within a short period to avoid the jump in the mortgage rate. The mortgage refinancing presupposed that house prices would continue to rise. The collapse in the housing market necessarily meant a wave of future defaults in subprime mortgages. (Udell 2009, Acharya et al. 2009)

While the subprime defaults were the root of the cause, the major impact which led to systemic failure was the collapse of two highly leveraged Bear Stearns –managed hedge funds that invest in subprime asset-backet securities. So when the shocks lead to burst of the asset bubble and trigger a process of deleveraging according to Acharya et al. (2009) the following consequences happen:

"1) The fall of the value of the bubbly asset backed by high leverage leads to margin calls that force borrowers to sell the asset, which in turn starts to deflate in value.

2) This fall in the asset value now reduces the value of the collateral backing the initial leveraged credit boom.

3) Then, margin calls and the forced fire sale of the asset can drive down its price even below its now lower fundamental value, creating a cascading vicious circle of falling asset prices, margin calls, fire sales, deleveraging, and further asset price deflation."

The markets froze for months and lot of subprime lenders went to bankruptcy and massive write-downs were made. Recently the uncertainty has decreased, economy has recovered a little but high unemployment rate and government's debt have been kept up the uncertainty.

4 RESEARCH DATA AND RESULTS

The data used in this thesis consist of the financial statement data and the results of a corporate questionnaire. The questionnaire was made by Lappeenranta School of Business' department of accounting and finance and Hanken School of Economics in 2009-2010. The questionnaire consists of 63 questions and 860 corporate answered the questionnaire. The questionnaire result was combined with the financial statement data. The questionnaire questions used in this study are attached in the appendixes.

In the table 3 it is compared venture capitalist effect on SMEs. The testable variables are return on equity and asset, quick and equity ratios. These variables measures companies' productivity and solvency. In this research there were 71 companies with a venture capitalist. Table 3 presents that venture capitalist have not a positive effect on SMEs. Actually venture capitalist seems to have a negative effect on SMEs productivity.

Table 3. Venture capitalist comparing against all the SMEs used in the corporate questionnaire. These are average numbers calculated from the data.

	ROE	ROE t-1	ROA	ROA t-1	Quickratio	Quickratio t-1	Equity ratio	Equity ratio t-1
All	23 %	19,9 %	15 %	13,7 %	2,4	1,6	39,2 %	38,4 %
VC	22,5 %	19,8 %	15 %	13,6 %	2,4	1,6	39,2 %	38,4 %

The results in the table 3 are surprising. It is expected that venture capitalist have a positive effect especially on the SMEs productivity and might have a negative effect on the solvency ratios. This result seems to have an opposite conclusion. It also seems like that venture capitalists have not any special effect on the SMEs survival in the financial crisis because solvency ratios are same although it has been improving from previous year. Overall the ratios seem surprisingly same and there are not any major discrepancies.

Table 4. The question for table 4 is how much followed arguments have effect on the company during financial crisis? Answer: 1=little, 5= much. The numbers presented are averages.

	All	VC
Financial crisis decrease companies sales	3,27	3,28
Financial crisis decrease companies profitability	3,24	3,25
Lack of financing compromising future of the company	2,18	2,18
Financial crisis increase the risk of bankruptcy	1,91	1,91
Overall the financial crisis interfere the company business	3,12	3,12

Table 4 presents companies own estimate of the effect of the ongoing financial crisis. The results shows that financial crisis have more negative effect of the companies with a venture capitalist. The companies without venture capitalist have a little bit brighter estimate of effect of the financial crisis. Overall table 4 presents that financial crisis have a negative effect of the companies, especially of the company's sales and profitability.

In this research we only scratch the surface on the venture capitalist effect on SMEs. Still it would be expected to have more variation in the results. Nevertheless the results show that venture capitalists seem to have a negative effect to the SMEs when it is compared to its peer's without a venture capitalist. Further research should compare deeper on the venture capitalist effect on SMEs and after financial crisis compare how companies are recovering from that.

5 CONCLUSIONS

In this thesis a venture capitalist investment on Finnish small and medium size companies are studied. The specific objective of the thesis has been the effect of the venture capitalist to the SMEs. In addition the effect of the financial crisis has also been studied. The theories effecting to SME investment has been presented to provide background information.

SMEs and venture capitalists are crucial part of the economy worldwide including in Finland. It is important to provide variety results from different views of these subjects to understand those deeper. World is changing constantly so it is important to study these constantly. Now it is crucial to learn more about current financial crisis and provide solid information from the financial crisis that SMEs and venture capitalist could prepare better for future challenges. Enthusiasms to understand these topics better give motivation for this thesis.

First this thesis provides major theories and the most essential results from the previous researches from this field. It gives understanding from SMEs, venture capitalists and financial crisis. Thesis also presents a new research of the effects of the venture capitalist on SMEs.

The results of this thesis are surprising. It would be expected that venture capitalist have a positive effect on SMEs. Nevertheless according to the results venture capitalist have a slightly negative effect on SMEs when comparing it to its peer's without a venture capitalist. SMEs with a venture capitalist have more negative outlook for future in the financial crisis and they estimate that financial crisis effect the company's sales and profitability more than it affects companies without a venture capitalist. Although there are not any big discrepancies of the results between SMEs with or without venture capitalist.

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APPENDIX 1: THE QUESTIONNAIRE

9. Onko yrityksessänne pääomasijoittajia?

1.Kyllä 2.Ei

51. Missä määrin seuraavat meneillään olevan rahoitusmarkkinakriisin/laskusuhdanteen vaikutuksen yrityksenne toimintaan pitävät paikkansa?

Paljon 5 Vähän 1

.1 Kriisi alentaa yrityksemme myyntiä

.2 Kriisi alentaa yrityksemme kannattavuutta

.3 Rahoituksen puute vaarantaa yrityksemme tulevaisuuden näkymiä

.4 Kriisi nostaa yrityksemme konkurssiriskiä

.5 Kokonaisuutena kriisi vaikeuttaa toimintaamme