Int. J. Entrepreneurial Venturing, Vol. 4, No. 3, 2012 195

Editorial: Research on entrepreneurial finance – today and tomorrow

Michael Olbrich

IWP Institut für Wirtschaftsprüfung,
Saarland University,
Campus, B 4.1, D-66123 Saarbrücken, Germany
Fax: +49-681-302-71211
E-mail: olbrich@iwp.uni-saarland.de

1 Introduction

The success of a new business mainly depends on two factors: the uniqueness of the business model and the ability of the entrepreneur to properly turn this idea into reality. However, it is also because of these two factors that entrepreneurial initiatives almost always go together with certain challenges. On the one hand, due to the singularity of the business concept, there are no experience values on which one can draw upon when appraising a new venture's strengths and weaknesses. Moreover, since there is no data history at all, or just a very short one, the forecast of a young company's turnovers and profits turns out to be an extremely demanding task. On the other hand, it is often the case that although the entrepreneur does have the technical skills to develop the product or service he has in mind, he lacks the required funds (Olbrich, 2002; Hering and Olbrich, 2002), business experience, and/or network to put his ideas into reality. Furthermore, entrepreneurial firms act in the environment of a highly imperfect capital market. This means in particular that debit and credit rates are unequal, the market participants' ability to raise capital is limited and their tax burdens and information levels differ (Dixon, 1991; Hering, 2000; Brösel and Matschke, 2004). The problem of information asymmetry, for example, is pronounced in cases where the entrepreneur comes from a high-tech background. In such cases, it is often difficult to communicate the business idea to potential investors (Dixon, 1991), which in the end makes a proper evaluation of a new business very difficult.

At the bottom line, entrepreneurial undertakings mostly go along with a high degree of project-driven, market-driven, and human-driven uncertainties; that is true for the entrepreneur in general and his financiers in particular. In this context, the research discipline of entrepreneurial finance can make valuable contributions on different levels. This is expertly shown in seven articles that this special issue comprises. Overall, three important areas of concern are tackled:

- *Asymmetrical information and agency problems:* In his pioneering piece, Akerlof (1970) concluded that mechanisms could arise in an imperfect market which reduce information asymmetry and thus keep the market functioning. As the venture capital market is an utmost imperfect market, this area of research is of special interest. Valliere, therefore, concentrates in his article on quality signalling between participants of early-stage investment markets, whereas Achleitner, Bock and Tappeiner investigate the nature of financial covenants in leveraged buyout loan agreements in the context of the latest financial crisis.

- *Valuation:* Valuation plays an important role in venture financing. For instance, when shares are issued to business angels or when an IPO is prepared, the parties involved have to determine the minimum/maximum price they have to demand/are able to pay if they do not want to change their initial wealth position for the worse. However, due to the capital market imperfections as well as the high degree of uncertainty, valuation models have to fulfil multiple requirements. Brösel, Matschke and Olbrich as well as Lerm, Rollberg and Kurz present approaches to valuation which feature a technique sophisticated enough to fulfil these requirements.
- *Entrepreneurial infrastructure:* Entrepreneurial actions can take place in very different settings (e.g., in less developed countries or within a franchising system) and support for those undertakings can be provided in very different ways. Even though the most important measure of supporting an entrepreneurial business certainly is the provision of liquidity, non-financial support seems to be of great importance, too. Klingelhöfer, Aiyepola and Adewunmi very much like Kußmaul, Waschbusch, Knoll, Staub and Ruiner analyse and evaluate very different settings of entrepreneurial financing in their articles. While the first focus on microfinance in South Africa, the latter aim to determine the impact of a financial or economic crisis on a franchising business. Gantenbein and Engelhardt in turn focus on non-financial support investors give to early-stage companies.

2 Article overview

2.1 Asymmetrical information and agency problems

Valliere's article 'Quality signals in early-stage venture capital markets' discusses how market participants overcome information asymmetry with the help of quality signals. The author develops a network market model that is based on a dyadic exchange of values and private information. In a first step, Valliere analyses the structure of the early-stage venture capital market by forming dyads of market participants and explains how they exchange value. In a second step, he examines each of the dyads from a signalling perspective and explains how both members of the dyad could benefit from signals of quality. Hereby, he establishes a rationale for a bidirectional signalling regime for each dyad. On the basis of his findings, Valliere eventually formulates ten propositions that might be subject to future empirical research.

In their article, 'Financial covenants and their restrictiveness in European LBOs – an assessment in the aftermath of the financial crisis', Achleitner, Bock and Tappeiner concentrate on a mechanism that mitigates the consequences of capital market imperfections on leveraged buyout (LBO) transactions – financial covenants. Usually, loan arrangements in an LBO transaction are declared between the financial sponsor (borrower) and the lead arranger (lender). The literature states that agency costs known as 'incentive effects of debt' (Jensen and Meckling, 1976), which can evoke opportunistic behaviour by the financial sponsor, can occur in this principal-agent relationship. Through a European-wide empirical study, Achleitner, Bock and Tappeiner assess whether financial covenants are seen as means to prevent this opportunistic behaviour by the borrower and whether they are seen as means that allow the lender to intervene with business in case of a breach of the covenants. Furthermore, the authors aim to review the development of the restrictiveness of financial covenants (measured by the headroom) during the last financial crisis and to figure out the main drivers of covenant restrictiveness. Like Valliere, also Achleitner, Bock and Tappeiner conclude their article by making propositions which can be tested in future empirical research.

2.2 Valuation

In their article, ‘Valuation of entrepreneurial businesses’, Brösel, Matschke and Olbrich describe the functional theory of company valuation as an alternative approach to valuation. First of all, the authors work out the characteristics of small businesses and show that traditional methods like multiples, DCF, and real option approaches cannot handle the specifics of those valuation objects adequately. With the future earnings method and the state marginal price model, Brösel, Matschke and Olbrich then present two tools to derive the decision value of the entrepreneur. On this occasion, they also consider the problem of uncertainty and come to the conclusion that the way DCF methods process risk is flawed in many respects, while a Monte Carlo simulation leads to better results, in particular because such simulations show the complete range of possible outcomes of the decision value.

Lerm, Rollberg and Kurz customise the state marginal price model introduced by Brösel, Matschke and Olbrich in their article ‘Financial valuation of start-up businesses with and without venture capital’ in such a way that an explicit quantification of the financial consequences of venture capital to a new business becomes possible. To do so, they develop a three-step-model in which the entrepreneur initially optimises his investment and financing programme (portfolio) without considering the business venture. Subsequently, the business is included into the portfolio in order to value its contribution to the entrepreneur’s wealth. The last step comprises a second valuation of the business; now also considering the venture capital available.

2.3 Entrepreneurial infrastructure

As stated above, non-financial forms of support given to new businesses play a notable role in early-stage financing. Therefore, in their article, ‘The role of investors for early-stage companies’, Gantenbein and Engelhardt conduct an empirical study on the Swiss market to shed light on the different types of support investors give beyond the provision of capital, their importance to the entrepreneurs receiving them and their benefits for the entrepreneurs. The results of the study show that there are seven measures of support. The provision of contacts and access to networks turns out to be the most important one apart from financing, since this measure provides the entrepreneurs with new customers, suppliers, or employees.

In their article, ‘Micro enterprises and microfinance for business women in rural areas of South Africa – a case study of Ga-Rankuwa at the interface between first and third world’, Klingelhöfer, Aiyepola and Adewunmi undertake an investigation of the microfinance infrastructure in South Africa by evaluating its status quo in the first part and assessing the development potential in the second part, hereby taking into account the example of the township Ga-Rankuwa. The analysis shows that the fact that South Africa is at the socio-economical border between the industrialised and the developed world poses a major obstacle for microfinance implementation. However, the authors argue that a sustainable microfinance system could be established in a township like Ga-Rankuwa due to its economic framework conditions.

Kußmaul, Waschbusch, Knoll, Ruiner and Staub elaborate the advantages and disadvantages of franchising systems in their article ‘Franchising – a key to success in times of financial and economic crises?!’ thereby focussing especially on how stable such systems remain in face of a financial or economic crisis. In the first part of the article, the authors describe the franchising business in general and as an alternative way of starting a new business by taking both, the perspective of the franchisor and of the franchisee. The second part of the article is then devoted to an empirical study. Among other things, the study shows what franchisors and franchisees consider to have been the advantages of a franchise system during the crisis, how much they feel the franchising system changed during that phase and in which way they have been affected financially.

3 Future research

Reading through the articles of this special issue, it becomes obvious that research in the field of entrepreneurial finance cannot take place under the assumption of an idealised market setting. Instead, it is necessary to explicitly take into account the actual specifics of the research object (namely the entrepreneurial business), to emphasise the high degree of uncertainty and to develop methods that are able to deal with drastic market imperfections. Having said this, it is astonishing that so far there is only little research, especially in the area of valuation, which considers those factors. Rather too often the literature recommends approaches to valuation based on models of capital market theory whose premises cannot be fulfilled in reality, especially the capital asset pricing model and the arbitrage free pricing. Thus, there remains a lot of research to be done.

References

Akerlof, G.A. (1970) ‘The market for lemons: quality uncertainty and the market mechanism’, *Quarterly Journal of Economics*, Vol. 89, No. 3, pp.488–500.

Brösel, G. and Matschke, M.J. (2004) ‘Zur Ermittlung des Entscheidungswertes kleiner und mittlerer Unternehmen’, *Zeitschrift für Klein- und Mittelunternehmen – Internationales Gewerbearchiv*, Vol. 52, No. 1, pp.49–67.

Dixon, R. (1991) ‘Venture capitalists and the appraisal of investments’, *Omega – International Journal of Management Science*, Vol. 19, No. 5, pp.333–344.

Hering, Th. (2000) ‘Das allgemeine Zustands-Grenzpreismodell zur Bewertung von Unternehmen und anderen unsicheren Zahlungsströmen’, *Die Betriebswirtschaft*, Vol. 60, No. 3, pp.362–378.

Hering, Th. and Olbrich, M. (2002) ‘Einige grundsätzliche Bemerkungen zum Bewertungsproblem beim Börsengang junger Unternehmen’, *Zeitschrift für Betriebswirtschaft*, Vol. 72, Special Issue No. 5, pp.147–161.

Jensen, M.C. and Meckling, W.H. (1976) ‘Theory of the firm: managerial behaviour, agency costs and ownership structure’, *Journal of Financial Economics*, Vol. 3, No. 4, pp.305–360.

Olbrich, M. (2002) ‘Gründungsfinanzierung und Portfoliocontrolling’, *Zeitschrift für das gesamte Kreditwesen*, Vol. 55, No. 24, pp.1308–1312.