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Article

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Journal of Entrepreneurial Finance

Provided in Cooperation with:

The Academy of Entrepreneurial Finance (AEF), Los Angeles, CA, USA

Suggested Citation: Yazdipour, Rassoul (2001) : Venture Financing and Role of Certification: A Theoretical Perspective, Journal of Entrepreneurial Finance, ISSN 1057-2287, The Academy of Entrepreneurial Finance (AEF), Montrose, CA, Vol. 6, Iss. 1, pp. 156-160

This Version is available at:

<https://hdl.handle.net/10419/114717>

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VENTURE FINANCING AND ROLE OF CERTIFICATION: A THEORETICAL PERSPECTIVE

Rassoul Yazdipour

ABSTRACT

This paper attempts to extend the Certification Paradigm- mainly used in the literature as an explanation for IPO underpricings- to provide guidelines to entrepreneurs in their efforts to secure funding for new ventures. After extending the model to cases of pre-venture-capital start-up firms, along with the practical implications that would follow, efforts are made to derive some testable hypotheses for further research on the topic.

I- INTRODUCTION

Historically, it is estimated that the capital need of entrepreneurial companies in the United States has been around \$60 billion a year. However, if we consider the recent “.com mania” as an anomaly, only a small portion of this amount has been traditionally financed by venture capital investors. Even if we add to the traditional flow the approximate \$10-20 billion funding that apparently come from private individuals (angels), still a very large number of entrepreneurial companies remain un- or under-funded. Furthermore, the majority of venture capital has traditionally gone to late-stage ventures. Specifically, on average, only 13% of the total venture capital investments have gone to early stage enterprises. This leaves all those start-ups that need funding the most in the dark.

The question then is, why so many ventures with possibly good market potentials never get to a meaningful funding stage and have to either shut their doors without having gone very far, or scale back their operations? In this brief paper, we attempt to provide an answer to this important question from two related angles as discussed in the followings.

First, one possible explanation regarding the funding problem for new ventures may come from the extended version of a theorem that has become known in the finance literature as Certification Paradigm. As will be detailed in Section II, the extended theory offered here states that deserving new ventures should be able to secure funding for start-up or growth purposes provided that they overcome the information asymmetry enigma they shoulder. This will only be accomplished through a third-party “certification” process. Following the same reasoning used in analyzing IPO underpricings, in this paper we argue that the existence of a credible certifier is a pre-condition to obtaining private funding for new ventures. We hypothesize that well-designed and promising ventures that could not raise their needed capital for either start-up or growth purposes, failed to obtain the required third-party certification. We will also see that given the fundamental changes in the mode of production and distribution, the definition of certifier can be expanded to include specialized types of vendors: For example, Value Added Resellers (VARs) and trade publications in the computer/IT industry, and suppliers of “strategic capital”, etc.

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The Journal of Entrepreneurial Finance 6(1)

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Second, we argue that failure to obtain private capital has another dimension to it that may explain the perceived funding problem. And that is the major emphasis traditionally placed on *external* sources of capital- as opposed to “*internal*” sources. The root of this problem however can be traced to the “industrial” age, where capital was a *separate* factor of production. Under this system, the industrialist/entrepreneur *first* needed the money to combine it with labor and “land” in order to make a product for some profit. However, in today’s knowledge-based economy, role of capital has been somewhat diminished. Today, it is not necessary to have (all) the capital first to start a business or expand one. Technology-based companies, which are now the dominant players in the U.S. economy, are good examples in this regard. As we will see more clearly in the next section, the change in the mode of production from industrial to technology, has given the certification paradigm an edge over other competing theories in explaining the capital shortage- both real and perceived.

Our main purpose in this short paper is to provide an explanation as to why some firms can receive funding while others can not. Here, based on Akerlof’s original work, as well as following the capital raising practice in today’s world, we will extend the Certification Paradigm to include the pre-IPO and pre-venture-capital stages of financing for a given firm. We will also develop some testable hypotheses, as well as a testing methodology, for the extended model. The extended model has some very important, and yet very practical, implications for all entrepreneurs and their backers in all industries in search of capital. Section II briefly discusses both the mainstream theory and the extended version, which is the main highlight of this paper; along with the testable implications for the extended model. Section III concludes the paper and provides some suggestions for future research in this area.

II- THE CERTIFICATION PARADIGM AND ITS APPLICATION FOR VENTURE FINANCING

A. THE MAINSTREAM THEORY/APPLICATION

It is common knowledge that investors’ uncertainty regarding the success of a given promising venture is responsible for the fact that such a venture may not receive the financing that it needs and deserves. Known in the literature as Information Asymmetry, such phenomenon causes the venture capital market to collapse if neither the entrepreneurs nor the investors try to eliminate or reduce the information gap surrounding the existing ventures.

Briefly, the mainstream Certification Paradigm- primarily used within the context of *public markets*- is based on the premise that, compared with everybody else (outsiders), the entrepreneur (insider) has superior knowledge about his/her venture (resources, abilities, and shortcomings) and that he/she can exploit the situation by providing false information to outsiders and especially to investors regarding the venture. Knowing this, investors will not invest in the entrepreneur’s project until and unless all the relevant information regarding the venture is available to them so that they could make objective investment decisions concerning the business. However the entrepreneur, being concerned about the theft of his/her proprietary knowledge and information, will not share the vital details of his business with anybody else unless the interested parties commit to the venture. In such a situation the market for venture capital will fail and projects have to be cut back extensively or canceled altogether. One way to bring back the market however is to have a bonded third party- one who will be penalized if he/she does not communicate the true value of the venture to investors- to certify the credibility of the entrepreneur and his/her venture.

Reputable investment bankers and professional venture capitalists (VCs) have always used their “reputation capital” (bonding) to certify IPO-issuing firms; and therefore enabling them to raise capital in the *public markets* rather smoothly and more efficiently.

Akerlof (1970) was the first to bring the certification hypothesis to light and examine it rigorously. His discussion of the Lemons Principle set the stage for dealing with uncertainty in terms of “insider information”, “trust”, “signaling”, “guarantee”, and “certification”. Later, Leland and Pyle (1977) argued that “*actions* of entrepreneurs (‘which speak louder than words’)- that is investing their own money in their own ventures- was a pre-requisite to receiving outside funding. Myers and Majluf (1984) applied the theory to

decisions regarding the issuance of bonds and stocks in a public market. Booth and Smith (1985) applied the paradigm to the underwriting function and triggered a considerable flow of research especially as they relate to the role of investment bankers, auditors and venture capitalists in bringing IPOs to the market. More recently (1998), Carter, et al have looked into the long-run performance of IPOs in light of the reputation of their respective underwriters. Specifically, certification hypothesis has been used in examining how investment bankers and auditors, and more recently professional venture capitalists, help resolve the information asymmetry between the issuing companies on the one hand, and stock market investors on the other hand. Examples in this regard include DeAngelo (1981), Grinblatt and Hwang (1989), Beatty (1989), Barry, et al (1990), Carter and Manaster (1990), Megginson and Weiss (1991), James (1992), Lin (1996), and Carter, et al (1998).

B. THE EXTENDED THEORY/APPLICATION

As stated in section I, the certification model can easily be extended to include entrepreneurial firms seeking capital in the *private markets* for either start-up operations or future growth purposes. This latter proposition is even more important than the IPO applications alluded to earlier. There are at least four reasons for this. First, very little, if any, of the available venture capital goes to seed and start-up companies. Besides, according to venture capitalists themselves, nine out of ten business plans do not even reach the desk of a general partner at a VC firm. Additionally, in 1995, D&B Market Identifiers Database reported the existence of 119,000 companies in the U.S. However, out of such a large number of companies, only 14,000 are publicly traded and the rest remain private with majority being smaller entrepreneurial firms. Second, even if all of the venture capital goes to start-ups, still an apparently huge financing gap totaling \$30-40 billion would remain. Third, the perceived capital shortage can be as disheartening as the real capital shortage to the entrepreneurial company. As mentioned in above, in today's information-based economy, capital is losing some of its traditional power when it comes to starting and growing new companies. The reason is that most of the new ventures are knowledge-intensive; and not capital-intensive. And although this may seem clear enough to us, yet many entrepreneurs do not see it that way and therefore help is needed to explain the new "capital game". Fourth, based on actual capital raising observations and experiences- including this author's own firsthand experience with venture investors and especially private investors over a relatively long time period- many investors in fact require third-party certification.

To explain the extended paradigm and its application, we need to remind ourselves that for pre-IPO, pre-VC firms, the backing of classical certifiers, like investment bankers and professional venture capitalists, are not readily available, by definition. However, entrepreneurs in the new economy have three expanded choices available to them as far as early-stage certification is concerned.

First there is the traditional possibility of certification by private investors (angels). This group plays more or less the same role that professional venture capitalists play for the advanced-stage companies. Private investors not only invest their money in their favorite ventures, but more importantly they add credibility and reliability to such ventures. Once there is a lead private investor in a venture- especially if such investor is highly reputable and well known in the community- other investors would follow subsequently. Depending on the size of their investment, these individuals usually become insiders and by bringing their colleagues on board, they can place a venture on the fast track. The point we want to make here is that once a venture is lucky to receive financing from a credible and no-nonsense investor/backer, then such involvement can be seen by the investment community as an act of third-party certification. Once certified, the venture will have a much better chance for survival and further growth.

Second, there is the possibility of certification by "strategic partners"- which their number and their means have been growing very fast. In the new world, "monetary capital" (real capital supplied by VCs and angels) may not be as important as "strategic capital" or "resource capital".

Third, there is the possibility of certification by "insiders" or industry experts. Examples include

acceptance by Value Added Resellers (VARs) in the computer industry, trade publications like PC magazine or BYTE, etc. This last form of certification increasingly plays a major role in the success or failure of new ventures. Casual observation shows that once a product becomes a “hit” with this group, financial offers will not stop flowing into such companies.

Putting things differently, we can say that under the extended paradigm/application, entrepreneurs can obtain certification along three lines. These are:

1) Traditional Certification; 2) Self Certification; and 3) “Insider” Certification.

1. Traditional Certification. This is certification by private investors.

2. Self Certification. This includes the followings:

- 2.1. Certification because of prior experience of the entrepreneur with another successful venture
- 2.2. Certification because of success at the present time in product development or shipment
- 2.3. Certification because of success at the present time in building strategic alliances- which translates into sale

3. “Insider Certification. This is certification by:

- 3.1. Trade publications- PC Week, BYTE, etc
- 3.2. By vendors, eg VARs, other buyers
- 3.3. By other industry experts/clients.

In brief, we can say that the certification paradigm can not only explain return anomalies in IPOs, but also capital raising successes and failures in pre-IPO and pre-VC financings.

C. TESTABLE IMPLICATIONS OF THE EXTENDED MODEL

Based on our arguments up to this point, we can state that once a promising entrepreneur and his/her venture is certified, then that venture will have a much better chance for survival and further growth. Specifically, we suggest that:

A significant portion of the successful entrepreneurial firms still operating today should have been able to earn the support of some major certifiers- as explained in above- somewhere along the line early in their life cycle.

2. A significant number of the folded ventures should have failed to earn the support of some major certifiers- as explained in above- somewhere along the line early in their life cycle.

D. TESTING METHODOLOGY

The appropriate methodology for the test here is “event study”- in essence similar to the method commonly used in market efficiency tests. Here, this means studying and registering important events- and especially those events that translate into certification by any of the three groups of certifiers discussed earlier- since the inception of the venture under study. The annual Inc. 500 Special Reports, published by Inc. Magazine, are the natural places to turn to for sampling and testing.

III- SUMMARY AND CONCLUSIONS

To summarize, this paper extends Akerlof’s certification paradigm to include pre-IPO, pre-VC entrepreneurial companies. Attempt has also been made to show how the extended model’s testable hypotheses may be tested. We argued that possibilities for certification for new ventures have dramatically increased; and as a result, the need for “monetary capital” is not as great as it used to be. This, along with the practical implications of the extended model, should be good news to entrepreneurs. This should be especially true for entrepreneurs in the technology sector where new certification means are available. The power of the extended certification model lies not only in its logic, but also in its wide usage among venture investors in the real world. Future work is needed to test the model in a comprehensive way. Development of other testing methodologies can also help shed more light on the issue on hand.

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