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Venture Capital Course

Venture Capital and Cluster Development, or It takes a Community to Create Great VC

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Introduction

"Grow, dammit, grow!" shouts the front cover of the Economist (2010) this week.

This provocative headline spoke to the efforts underway at all levels of the economy to stimulate business activity and revive a limp recovery. Toronto's Globe and Mail proclaims: "An Innovation Strategy: A Coalition of Experts has come up with 10 ways to spur the creativity of businesses" (Globe 2010, page B3). The Conference Board of Canada says cities are where innovative business things happen in: "21st Century Cities in Canada: the Geography of Innovation" (Wolfe 2009). And the Government of Ontario's major report on competitiveness argues that "Ontario needs to get people, things and ideas moving again" (Ontario 2009).

With the Great Recession of 2008-2009 now, more than ever, the media, government, academics and business practitioners, are all obsessed with re-igniting economic growth, and attempting to spur innovation. But how do you get ideas moving again, promote innovation and create economic prosperity? Some have suggested venture capital ("VC") is one of the key catalysts to economic development, and that regionally-oriented venture capital is even more effective (Florida 1986).

I have been involved in private equity and venture capital, both corporately and personally, for more than a decade, and I have found that capital is not always available, even for good ideas, and that an activist investor is often much better than a passive, disinterested one. Many argue that capital is freely available, and that bankers and investors shouldn't interfere with management. That is not my experience. One of the best capital raising lessons I got was from a crusty old investment banker who said to our Board, "when the tea cart comes by, take some tea", because you never know if it will come by again; well, it's the same thing with debt and equity. I have also seen several companies where activist investors and financiers played an important, if not critical, role in the governance, strategy formulation and execution of many business plans, and other companies where independent directors were a disaster for a company. I fear too many founders, engineers and inventors, themselves excellent at technology, over-estimate their ability at business, marketing and finance. I also have seen how often interaction takes place between investors and investees in a start-up, or should take place, and how even a bit of distance, such that a meeting is delayed a week or two until its convenient, can be a disaster for such a complex undertaking.

This paper explores the role of regionally-oriented venture capital in innovation and economic cluster development. This paper will present the idea that the fire that gets ideas moving is regional/cluster venture capital and venture capitalists. Other factors are clearly important. The spark may be an entrepreneur (Carlsson 2009), the fuel may be the institutions and the infrastructure (Wolfe 2009), the location may be a cluster (Porter

1989), but to me the critical fire that ignites the economic development and keeps growth burning, is the local, actively-engaged venture capitalist.

According to creative cluster guru Richard Florida, "Venture capital plays a critical role in technological innovation and regional development by providing funds and helping to organize embryonic technology oriented companies" (Florida 1986, page 33). The New York Times in "It's Not the People You Know. It's Where You Are" reference the VC "20-minute rule" which says that, "if a start-up company seeking venture capital is not within a 20-minute drive of the venture firm's offices, it will not be funded" (Stross 2006). Venture capitalists are very different than banks, bankers and other more traditional sources of capital because they invest early in the formation of a company and are far more activist in their investee companies. This more activist involvement seems to be critical, particularly in the start up stages of new firm development. Some of the most dynamic innovation clusters have aggressive successful venture capital firms at their center. In contrast, government centered attempts at cluster development, without local VC firms, seem to have lacklustre success. According to a prominent Silicon Valley VC quoted in the New York Times article:

> "Close proximity permits the investor to provide in-person guidance; initially, that may entail many meetings each week before investor and entrepreneur comes to know each other well enough to rely mostly on the phone for updates. Those initial interactions are fateful. Starting a company is like launching a rocket. If you're a tenth of a degree off at launch, you may be 1,000 miles off down range" (Stross 2006).

According to Samila and Sorenson (2008), business and politicians, amongst others, have seen venture capital as a key factor causing economic growth in both certain regions within as well as an entire country. They cite several areas in the U.S., as well as Canada, Chile, Germany and Israel, as places that have attempted to grow local VC through public policy initiatives. However, despite the widespread interest in VC as a stimulus for economic, "little empirical research has examined the validity of these claims" (Samila and Sorenson 2008, page 1). They do reference studies that have shown that VC-funded companies bring products to market sooner, develop reliable routines more rapidly, and generally enjoy higher employment and sales growth rates than the average start-up (Samila and Sorenson 2008), which might suggest benefits for a region but it hasn't been proven. VC is surprisingly concentrated into a few locations world-wide:

> "From Silicon Valley to Herzliya, Israel, venture capital firms are concentrated in very few locations. More than half of the 1,000 venture capital offices listed in *Pratt's Guide to Private Equity and Venture Capital Sources* are located in just three metropolitan areas – San Francisco, Boston, and New York. More than 49% of the U.S.-based companies financed by venture capital firms are located in these same three cities" (Chen et al 2009, page 3).

This paper will analyse the regional location or cluster location of VC firms and also the impact of that location and involvement. Most of the academic and practitioner literature on the VC business does not address location, other than sometimes referencing the "20-minute rule" from a convenience standpoint. This paper will argue that location, and the community or cluster that the VC and investee are located in, is critical to the successful VC firm and to the firms that VC's invest in. To paraphrase Hillary Clinton, it takes a community to raise or create a great VC company.

This paper will first review the venture capital business to provide a basic understanding of how it is different from more traditional lending or investing, and the activist role played by VC's in comparison to the historically more passive role played by investors in other sectors. The paper will then analyse the regional or cluster characteristics of the VC business. Finally, the paper will conclude on the importance of the community/cluster nature of the VC business, and personal face-to-face interactions and social capital to the success of the VC, the investee companies, and the community or cluster.

The Venture Capital Business

Venture capital has been critical to the development of several industries such as information technology and biotech in the past several decades attracting more than 85% of VC investment (Florida 1986). Total invested dollars has grown from around $3 billion in the 1960s to nearly $20 billion by 1986 (Florida 1986) and to over $35 billion by 2007, a compound growth rate in the past 25 years of 15 percent (Samila and Sorenson 2008). A significant body of research shows that VC-funded firms outperform in many ways including: "i) operational growth, ii) post-IPO performance, iii) innovation and patenting activity, and iv) potential for scale" (Chen et al 2009, page 3). VC funded companies also create more jobs, revenue and market value (Chen et al 2009):

> "Venture capital is critical to growing the new businesses that will drive the 'new economy.' Finding ways to nurture the culture of entrepreneurs, and the capital that feeds them, must be the top priority of states" (Chen et al 2009, page 4).

Venture capital has evolved over the past few decades into a standard structure. Each VC firm typical has one or more limited partnerships, or funds, with life spans of 10 to 12 years. The capital comes from limited partners, such as high net worth individuals and institutional investors. The general partners actively manage the funds investing in high-potential investments, and monitoring and advising the investee companies. VC's receive both fixed compensation such as a management fee and a potentially sizable portion of the capital gains earned on these investments. Studies have found that VC investee firms have performed better than others on revenue growth, profitability and in time to IPO and have earned IRR's or 13-15 % on average, which is above the average for all small- and medium-sized companies (Samila and Sorenson 2008). "The preponderance of evidence therefore implies that venture capitalists create value for their investors by selecting and cultivating high-potential companies (Samila and Sorenson 2008, page 8). "A good VC will help entrepreneurs build their companies" (Senor 2009, page 161).

Venture capital firms invest in firms in stages by usually first acquiring a majority equity stake in the businesses they finance often initially on their own. As capital requirements increase as the business grows, investments are usually syndicated to an increasing number of co-investors. Co-investment is done by 75% of VC firms and 90% of deals are syndicated (Florida 1986). Venture capital firms are not the typical disinterested banker but are critically involved in the strategic and operation issues a start up company faces but via board membership and consulting activities and not through direct operational involvement or positions. According to Florida (1986) "numerous studies of venture capital firm behaviour such firms are involved in review and clarification of business plan proposals, definition of financial requirements, initial market analysis, management recruitment, evaluation and/or replacement, location of co-investors, assistance with initial public offerings and acquisitions. The active and ongoing nature of investing is further indicated by survey data which reports that venture capitalists prefer investments located within a 150-250 mile commuting distance from their home office" (Florida 1986 page 35).

The table below depicts the relationships between financial and non-financial activities over the course of a typical venture capital investment cycle.

Life cycle of a technology-oriented, venture capital new enterprise

Venture capital Activities	Seed	Start-up	First stage	Expansion	Liquidation
Income	loss	some annual income	Break even	cumulative net income	cumulative break even
Stage of business	Concepts, R&D	Product Development	Initial commerciali-zation, start production	Expansion of products and sales	Initial Public Offering or Merger
Non-financial activities of VC firms	Review and clarify business plans	Recruit manager conduct market analysis	Assist with production start locate co-investors	Build up marketing and sales staff change management locate co-investors	Assist with IPO or merger
Capitali-zation	< $1 MM	$1 - 5 MM	$5 - 10 MM	$10 - 50 MM	> $ 50 MM
Time	1-3 years	1-3 years	2-3 years	1-3 years	5 - 10 years in total

average timeframe is 7 years

Source: Florida 1986

Historical factors were the cause of why one area is a financial- versus technology-centred VC center. The establishment of Boston's American Research and Development (ARD) in 1946 was probably the first VC company, and it started the modern venture capital industry (Ante 2008). Although ARD was the first institutionalized venture capital firm, its primary catalysts were a Harvard Business School professor and a group of prominent bankers and industrialists who all saw a VC firm as a way to revive New England after WWII and to more effectively finance technology-oriented enterprises. First National Bank of Boston also started providing money to MIT-based start-ups, and became a conduit for the Boston area VC investments of New York venture capitalists.

In Creative Capital: Georges Doriot and the Birth of Venture Capital, Ante (2008) describes the need for a new investment vehicle after WWII and states that for these men:

> "ARD would solve a major imperfection of modern U.S. capitalism: new companies were starved for money and professional management…. After the war, entrepreneurs had a difficult, if not impossible, time raising capital. Banks were ultra-conservative, reluctant to lend money to unproven ventures… Venture capital was all about taking huge but calculated risks (Ante 2008, page xvi – xvii)."

This book, by explaining the birth of venture capital, and the champion who really started American VC, describes well the attributes of a successful VC. Doriot had a patient investment philosophy, believed in building companies for the long-term, and not flipping them, and he believed that attractive returns were the by-product of hard work, not the objective. He went against then conventional wisdom, and proved that money could be made from patient investment and nurturing of small risky ventures. "He often referred to his companies as his children" (Ante 2008, page xvii). Doriot and ARD's enormously successful investment in Digital Equipment Corporation, the first VC-backed IT company, provided the needed proof that the venture capital model and industry could develop great companies, technology and substantial investment returns. Staff from ARD launched many of the other successful VC companies both in Boston and elsewhere in the U.S. When ARD sold DEC, its value was $400 million and yielded a 70,000% return on ARD's investment, and created the Route 128 technological cluster around Boston.

Doriot, an HBS professor, had a magnetic personality, and the needed persistence and charisma to start a new industry (Ante 2008). In addition to venture capital, he lectured his students about the importance of innovation, globalization, productivity, "how to pick a wife", and stressed themes such as self-improvement, punctuality, teamwork and contributing to society (Ante 2008). He believed that "innovation, continuous innovation, never relaxing, was the only way to stay ahead of the competition" (Ante 2008, page xv). Ante's (2008) book about Doriot and the VC business is an excellent review of both the individuals and the principles they followed to build a new business, VC, and to grow technology oriented companies that they feared would die but for this new form of capital. Doriot is quoted as saying:

> "A creative man merely has ideas; a resourceful man makes them practical. I look for the resourceful man (Ante 2008, page xv). He also stated in his 1949 annual report, "an average idea in the hands of an able man is worth much more than an outstanding idea in the possession of a person with only average ability (Ante 2008, page 123).

Doriot believed that the role of a VC was to "coach, guide and inspire" (Ante 2008, page 121) but almost always their investments met with catastrophes and it was critical for the VC to get very involved. "The hardest task is to help a company through its growth pains," said Doriot (Ante 2008, page 121). ARD philosophy was to go beyond just investments and "include managerial assistance and technical advice when necessary" (Ante 2008, page 114). They insisted on board positions and management consulting contracts and fees. "It wasn't a question of who has control but of getting the right kind of control" (Ante 2008, page 114).

In the 1949 report Doriot summarized, "A team made up of the younger generation, with courage and inventiveness, together with older men of wisdom and experience, should bring success" (Ante 2008, page 114).

Doriot laid out his investment philosophy in a 60's speech called "Creative Capitalism":

1. "The riskiest part of the spectrum has to date proven the most rewarding, and the greatest capital gains have been earned in companies which were started from scratch.
2. Most venture investing has not been built on achievement of dramatic overnight successes, but on the steady growth of soundly-based, well managed affiliates.
3. Technology has proved a rewarding filed for ARD and is particularly well suited for creative capital investment…
4. There is always an important job to be done. There is a sales door to be opened, a credit line to be established, a new important employee to be found, or a business technique to be learned. The venture investor must always be on call to advise, to persuade, to dissuade, to encourage, but always to help build. Then venture capital becomes true creative capital – creating growth for the company and financial success for the investing organization" (Ante 2008, page 173).

Creating the VC business was not without its challenges. During a ten year fight with the SEC over the accounting for stock options Doriot explained, "Companies come to ARD for financing because they prefer private ownership to premature public ownership… ARD has more knowledge of what is right and wrong than the average person at the SEC" (Ante 2008, page 184). Doriot attacked the SEC's lack of understanding of venture investing and its methods versus more typical large public manufacturing companies and the agency's confrontational stance to those that were building the technological companies of tomorrow. The SEC's lack of knowledge for the risks of investing in technology and lack of appreciation for the importance of venture capital was absurd to Doriot. The tragedy and irony of this regulatory fight was that ARD was attacked just as the market was recognizing the importance of VC investing and Doriot's achievement. According to Doriot's auditor:

> "Some of the SEC examiners did not know what they were doing. They did not want to be intellectually challenged" (Ante 2008, page 186). Because the "SEC line up ARD in its crosshairs" (Ante 2008, page 189), ARD was forced to IPO DEC. "ARD's initial $70,000 investment had skyrocketed in value by a factor of five hundred, validating Doriot's model and proofing the short-sightedness of SEC inspectors" (Ante 2008, page 196).

DEC was the VC industry's first huge success and proved to investors, entrepreneurs, academics and economists the validity of the VC model. Doriot's vice president described the DEC IPO and its impact this way:

> "I'd say it was a sea change in the attitudes toward venture capital investing. There really had never been a phenomenal, enduring success. It was really mind-blowing that you could take such a small amount of seed capital and get ownership of a company that was worth more than IBM in a fairly short period of time" (Ante 2008, page 197).

Doriot was named Business Statesman of the Year and concluded his speech with a challenge to think about your contributions and set a mission together this way:

> "On a road, three men were breaking stones. When asked what they were doing, one said, I earn a living, another, I break stones, and a third, I help build cathedrals. So let us build cathedrals together" (Ante 2008, page 199).

Doriot's biggest successes were with local companies such as DEC where he played a long-term activist role in the company, so much so that the founder thought of him as a mentor and a father figure. Ken Olsen of DEC said, "He was always there as a mentor and a help. Most of his ideas he didn't present in a way you had to accept. He presented them in a way which, after it was done, you thought you had thought of them yourself. (Ante 2008, page 179). His failures were in more silent investments further afield from Boston.

"The VC Rules: When you want venture-capital know how to make your move", (Dalton 1997) explains that because only 1% of pitches actually get funded by VC's, you really need to follow some "VC rules" to be successful. Dalton (1997) suggests the keys are defining your market, building the right team, having a unique product and being able to "learn the language of venture capital – There is a secret code, like a fraternity hand shake" (Dalton 1997, page 1). VC's want focus, customers that establish a product's viability, management that are willing to invest, and, most importantly, a willingness to share power. Inventors that are too enamoured with their technology, and don't know what they don't know about business, will not share power, and will more than likely not be successful. Having a VC invest in your company is an important vote of confidence with other VC's and the marketplace.

Fenn (2010), given the challenges in raising venture money today details in "Pitching Venture Capitalists: The Top Five Deal-Breakers" five useful cautions. The last and most important one for me is the importance of the VC being actively involved in the venture and the ventures acceptance of that – to treat it like a partnership. The Top Five Deal Breakers are:

1. Contacting every venture capitalist in the directory.
2. Setting unrealistic expectations, especially during the critical due diligence process.
3. Falling in love with your technology.
4. Dismissing current and future competitors.
5. Viewing the venture funding as a transaction instead of a partnership.

While VC is different than private equity, it is instructive that Morgan Stanley sees the challenges with the availability of leverage forcing private equity to focus on operational improvement and not just financial engineering. "While credit tightening has curtailed the availability of leverage and intensified competition for new deals, the economic recession has caused many companies already in the portfolios of private equity firms to underperform. These changes are prompting investors to revisit a long-held key tenet of value creation in private equity: operational improvement" (Matthews 2009, page 21). They describe three types of involvement with the investee company with increasing levels of involvement: the Elder statesman, the in-house consultant, and the integrated partner. They outline the following steps in two stages as the keys to focus on in investment deals for activist investors:

1. Deal Process
    a. Deal Flow
    b. Business Evaluation
    c. Due Diligence
    d. Deal Structure, Financing and Close
2. Asset Process
    a. Talent
    b. Strategy and Implementation
    c. Financing and Acquisitions
    d. Exit Process

Source: Matthews 2009, page 23.

According to a recent presentation at an Innovation Conference in Mississauga, a study of Canadian venture capital found that the top two reasons for failure were problems with the technology and problems with governance. Learning to work together, sharing power and playing an active but non-intrusive role in management has come up again and again (Pascoe 2010). Investing with people you know, in a cluster, who you have relationships with, is a great way to ensure trust and "social glue".

Clusters and Venture Capital

In a supposedly "Flat World" venture capital investment is surprisingly "spiky" in its location. In Florida, written in 1986, they found the strong plurality of VC investment in the United States took place in only two locations, Silicon Valley and Boston, and 60% was invested in only three states, California, Massachusetts and New York (Florida 1986). Why, with ease of transportation, communication and the movement of capital, would such a concentration of both VC firms and VC investments occur? There must be something special happening in centers of VC activity.

Industrial clustering was first described by Marshall in 1920, but then popularized more recently by Porter (1998), Krugman and now Florida (2009). A cluster is a concentration of interconnected institutions and firms focused on one industry including businesses, government and universities, along with suppliers and buyers, knowledgeable labour force and ambitious entrepreneurs. According to Wolfe (2009):

> "Innovation is increasingly recognized as a social process: it depends on interaction and social learning between economic agents. The city-region is a critical scale for innovation and creativity because spatial proximity between economic actors and the institutions that support their activity enable the easy circulation of knowledge (Wolfe 2009, page 15).

Clusters are not unique, however; they are highly typical – "and therein lies a paradox: the enduring competitive advantages in a global economy lie increasingly in local things – knowledge, relationships, motivation – that distant rivals cannot match" (Porter 1998, page 78). Clusters affect competition in three broad ways:

1. Increasing productivity.
2. Driving innovation.
3. Stimulating the formulation of new businesses which expands and strengthens the cluster itself.

Source: Porter 1998, page 80.

Porter's focus on new business formation is critical, so is diversity. The summary of what powers a cluster in a Montreal economic development report is instructive:

> "Regional economic growth is powered by creative people, who prefer places that are diverse, tolerant and open to new ideas. Diversity increases the odds that a place will attract different types of creative people with different skill sets and ideas. Places with diverse mixes of creative people are more likely to generate new combinations. Furthermore, diversity and concentration work together to speed the flow of knowledge. Greater and more diverse concentrations of creative capital in turn lead to higher rates of innovation, high technology business formation, job generation and economic growth" (Stolarick et al, page 1).

Clustering of VC is likely similar to the same forces that lead to other clusters, such as inputs, labour and knowledge spill over. But according to Chen et al (2009), venture

capital is even more concentrated than other entrepreneurial activity. To that, is the logical question, which came first, VC or the entrepreneurial companies, and they find that "venture capital may have the primary role in fostering the entrepreneurial communities in which they are located" (Chen et al 2009, page 4).

Venture capital firms locate where there is the greatest number of good investment opportunities to decrease search and monitoring costs. They will travel further afield, but only if greater returns provide compensation for doing so. Most VC investments are in higher knowledge intensive industries where knowledge spill-over is important.

> "A virtuous cycle of co-location is maintained as entrepreneurs choose to locate their businesses closer to funding sources, pools of talented employees, and academic researchers. The higher success rate for companies based in the venture capital centers suggests that these may be optimal geographies for founding new venture-backed businesses" (Chen et al 2009, page 26).

Florida (1986) found that there were two types of VC centers, financial ones and technology ones. Six or seven states / city regions accounted for most of the U.S. VC activity. Four states, California, Massachusetts, Connecticut and Texas were states with the highest number of and highest ratio of high technology jobs to all jobs. Minneapolis was next closest. New York and Chicago had the largest concentrations of financial resources in the United States (Florida 1986).

Doriot and ARD initially focused on Boston because of the presence of Harvard, MIT, Boston money and themselves. Doriot returned from war service, where he was critical in military and government financing of scientific and technical solutions to military and reconstruction issues, to teach at Harvard Business School and to start a private venture capital business. "Doriot would battle for the next twenty-five years against an array of domestic forces that included clueless government regulators, short-sighted lawmakers, and ultra-conservative investment managers" (Ante 2008, page 106). Doriot believed that venture capitalists were like matchmakers – marrying people with money to people with crazy new ideas. They feared that onerous taxes and ultraconservative investment trusts and only big businesses that did not have the imagination or risk profile to invest in new opportunities. Doriot believed in taking calculated risks in growth opportunities what were past the "test tube" stage, could be protected by patents or know how and would reap enormous profits. Doriot located his new business and most of his first and most successful businesses in and around Boston because of proximity to several top universities and the most important government / military research centers (Ante 2008).

Starting in the 1960's, Silicon Valley started taking over as the center for both technology companies and venture capital. Ante (2008) credits a greater acceptance of diversity, technologically oriented universities, and a visionary Stanford professor that saw the area as a nexus between academia and business. His vision was to rapidly transfer technology to the market from the university and research lab. Also helpful was a reporter that branded the area, Silicon Valley for the concentration of computer companies. "With world-class universities, a budding commercial track record, and a seasoned back of

entrepreneurs, the region was poised to take over the technology industry. All it needed was a steady supply of venture capital to fuel the fires" (Ante 2008, page 231). Initially the entire VC industry would meet once a week for lunch establishing a deep-rooted network. Kleiner, Perkins, was started by one alumnus of Fairchild Semiconductors and another from HP and was credited as being the first to establish hands-on management, a grouping of collaborating portfolio companies and rigorous quarterly governance, though ARD has really initiated such practices two decades earlier in Boston. They also incubated their own companies and created the "aircraft carrier" model where the encircled one venture with suppliers and service providers. Thirteen companies were established around Apple to supply for example (Ante 2008).

Samila and Sorenson (2008) in a study of "Venture capital, entrepreneurship and regional economic growth" for the Research Council of Canada found that a local supply of VC positively impacts the number of start-ups in the area, employment and aggregate income. They found that the presence of VC stimulates the start-up of more firms than just those that the VC funds fund. The implications are that entrepreneurs locate close to VC funds and that VC funds provide helpful to entrepreneurs through more than just cash, by spin-offs and demonstration of success and the network in a local cluster (Samila and Sorenson 2008). Their results imply that venture capital stimulates a doubling in the supply of venture capital in a region. They also found that a greater supply of venture capital stimulates entrepreneurship in the entire region and benefits local economies with higher average income, higher than is explained by just the VC backed firm alone (Samila and Sorenson 2008).

Bengtsson, and Ravid (2008) studies the Importance of Geographical Location on the type of VC contacts that were negotiated, and found that the closer the VC and the investee firms were located, the "less investor-friendly contracts…with fewer cash flow contingencies" (Bengtsson, and Ravid 2008, page 1). This finding suggests that if a VC is located close to a investee they rely more on monitoring and board representation while when further away they dramatically increase their contractual control. I found it fascinating that a subsequent version of this paper was entitled, "Location, Location, Location", Bengtsson, and Ravid (2009) stressing the importance of being close and convenient to your customers, just like a restaurant.

Bartkus and Hassan (2010) took an opposite look and found that "firms that are farther away from the venture capital funding them are less likely to achieve a successful exit" (Bartkus and Hassan 2010, page 75). They also point out the importance of VC monitoring of their investments and show that it declines with distance. They suggest that the monitoring and involvement is critical, and when absent, is replaced by contractual controls but which also results in poor results. Monitoring is the key difference between VC investing and commercial banking, which relies far more on hard data. "Hard information may be helpful to venture capitalist in their monitoring role, but the traditional role of a venture capitalist in the development of portfolio companies requires frequent contact with firm management, through phone calls or visits to the firms, and often sitting on the board of directors, among other responsibilities (Bartkus and Hassan 2010, page 76). They found that there are some other reasons for IPO or divesture exit

success including: portfolio company age, average fund size, venture capitalist reputation, and hot market years. They did not find that fund age was significant – so size counts for VC's as does reputation, but not age. It is interesting that so many criteria describing the VC impact the investee's exit success underlining how important VC presence is to entrepreneurial success. Controlling for all these factors, the most significant impact on exit success was proximity between VC and investee company, and they found that this factor has held over time, even as transportation and communication cost have declined and ease of access has increased. Proximity counts.

Dai (2007) found that based on a sample of US VC investments between 1980 and 2000, older VCs, and VCs with more previous investment experience exhibit stronger local bias. Dai point out that American investors and equity traders in the U.S. put 94% of their money into domestic investments even though the American market is only 48% of the global market. The rationale to invest local is because one has better information even in this world of easier global communication and global media. Home country bias exists in other countries also. In equity markets however, more experienced investors and more successful ones, exhibit less home bias. But Dai (2007) found the opposite in the venture capital, more experience ones invest closer to home. She points to three reasons why this difference exists:

1. Two sides to a VC investment – in VC investments the company has to agree to the investor as well.
2. Information asymmetry – VC investors find out about deals from businesses plans, conferences, and networks; geographical distance would harm deal flow.
3. VC investors often require frequent in-person contact with entrepreneurs both before and after making investments.
4. Physical distance restricts the ability of VC investors to closely monitor entrepreneurs, and attend board meetings.

Source: Dai 2007.

Stross (2006) described Silicon Valley as an ecosystem which includes "incredible techies, who live here because this is the epicenter, where they can find the most interesting projects to work on. The ecosystem also includes real estate agents, accountants, head hunters and lawyers who understand an entrepreneur's situation — that is, emptied bank accounts and maxed-out credit cards. It's harder for entrepreneurs to meet with one another and with investors, [elsewhere]. And that means connections take longer, deals move slowly, fewer companies are formed. Like a gas, entrepreneurship is hotter when compressed". Bengtsson, and Ravid (2008) describe Silicon Valley has having less strict firm boundaries, informal networks and dress versus a more formal culture in Rout 128 Boston and formal business suits.

Florida (2009) quotes Jane Jacobs as saying that dynamic urban clusters have intensive network interactions within business and social networks that provide "accelerated metabolism" and therefore are the place to start and grow businesses. Bengtsson, and Ravid (2008) describe interactions over events such as golf games and Rotary lunches that provide each side in a VC transaction with more and better information as well as a

favourable view of each other. “For active investors such as VC’s, home bias is particularly pronounced because geographical proximity could lower pre-investment screening costs as well as post-investment monitoring costs (Bengtsson, and Ravid 2008, page 3). It is also very interesting to note, given some of the well publicized banking challenges in the past few years, that Bengtsson, and Ravid (2008) reference as comparables studies of business banking that show that local banks do a far better job of credit checks and monitoring of local companies than larger more distant banks.

Start-Up Nation: The Story of Israel’s Economic Miracle is a comprehensive and fascinating review of innovation, entrepreneurship and venture capital that exists in Israel, making it one of the most successful and concentrated centers of innovation in the world today (Senor 2009). Israel is described as an ecosystem that generates radically new business ideas (Senor 2009, page ix) with “unique combinations of audacity, creativity and drvie” (Senor 2009, page 11) producing the highest density of start-ups in the world, more companies on the NASDAQ than all of Europe, and the highest per capita investment in venture capital (Senor 2009). Israel spends the highest percent of GDP on research and development in the world, has grown faster than other developed countries since 2000 and has doubled its share of global VC from 15% to 31% (Senor 2009).

The question of Start-Up Nation is:

> “How then, did this start-up state not only survive, but morph from a besieged backwater to a high-tech powerhouse that has achieved fifty-fold economic growth in sixty years? How did a community of penniless refuges transform a land that Mark Twain described as a desolate country, a silent, mournful expanse, into one of the most dynamic entrepreneurial economies in the world?... Look, we doubled our economic situation relative to America, while multiplying our population five-fold and fighting three wars. This is totally unmatched in the economic history of the world” (Senor 2009, page 15).

According to Senor (2009) the base for the spectacular growth was macroeconomic stability, finally after decades of instability, massive infrastructure investment, and an entrepreneurial culture where everyone was connected in an ecosystem. But then what accelerated the growth in the nineties were a new wave of immigration, the stimulative spending from a new war and venture capital.

Senor (2009) describes in great detail the entrepreneurial culture as a unique ecosystem that exists in Israel which combines:

1. “Chutzpah”, talent with tenacity, Israelis learn that assertiveness is the norm.
2. Cultural tolerance for constructive failures, or intelligent failures, and bankruptcy laws that make it easy to go bankrupt and then start again.
3. A culture of disagreement and debate. The goal of the leader is to maximize resistance – in the sense of encouraging disagreement and dissent. Challenge the obvious, ask questions, debate everything, and innovate.

4. Battlefield entrepreneurs that come from enforced military and reserve service. Everyone experiences the downward delegation of responsibility both by necessity and design. Inventing, adopting and disseminating new tactics in real time. Assertiveness versus insolence; critical, independent thinking versus insubordination; ambition and vision versus arrogance.
5. An internationalist attitude, probably from their regional alienation.
6. A culture of innovation. Branded Israel with stickers that said, "Israel Inside".
7. Interconnectedness and social range. Military life provides relationships, education and social range, a merit-based institution with people from all walks of life that you have to work together with in life and death situations. A team.
8. "Rosh gadol". Initiative, risk-taking and agility.
9. "Bitzu'ism" is a pragmatist who gets things done; crusty, resourceful, impatient, sardonic, effective, not much in need of thought, but not much in need of sleep either.

Source: Senor 2009, pages 16-18.

In contrast, America is currently described as Japan was in 1990 or "the Detroit of Nations" (Senor 2009, page 19); complacent, un-entrepreneurial, bloated on cheap credit, and no longer innovative or ambitious. Nobel prize winner Robert Solow argued that "technological innovation is the ultimate source of productivity and growth (Senor 2009, page 19) and stats show that between 1985 and 2005 greater than 100% of net new job growth came from firms younger than five years old (Senor 2009). Understanding where this entrepreneurial energy came from, where it's gone, why it exists so abundantly in Israel, and how to get it back in North America, is critical and the intention of this paper.

> "Israeli entrepreneurs…benefit from the stable institutions and rule of law that exist in an advance democracy. Yet they also benefit from Israel's non-hierarchical culture, where everyone in business belongs to overlapping networks produced by small communities, common army service, geographic proximity, and informality" (Senor 2009, page 100).

Fluidity, was coined by a few school of economists' entrepreneurialism, and is described as important for successful entrepreneurial activity, innovation and new start-up. Fluidity is produced when people cross boundaries, challenge societal norms, and practice creative destruction, all to create innovation and new radical ideas.

> "Asynchrony, a lack of fit, an unusual pattern, or an irregularity have the power to stimulate economic creativity… A bit of mayhem is not only healthy but critical (Senor 2009, page 99).

Senor (2009) concludes with a fascinating comparison of Israel and some of the near by Arab countries that have used oil revenues to attempt to create clusters. "The contrast between the two models demonstrates that a simplistic view of clusters – one that maintains that a collection of institutions can be mechanically assembled and out will pop a Silicon Valley – is flawed" (Senor 2009, page 214). It is the culture, the social

interaction and the VC that gives life to an agglomeration of companies, institutions and human capital.

Batjargal and Liu's (2004) study of venture capital in China found that entrepreneurs' social capital, often from local relationships or a school network, impacted the investment decisions of venture capitalists, and that strong ties between entrepreneurs and venture capitalists had a positive impact on contract terms, the time to get a deal done and the value of the venture.

There are several researchers that have tried to analyse the geographical proximity of VC and investees in Europe, and they found that only just over 40% of investments were made locally. However a fascinating review of these seemingly contradictory findings was performed by (Avdeitchikova 2005) where she came to the following conclusions:

1. The social network is more important in obtaining information on potential deals in home investments than in non-home investments. An investor's social capital is therefore regionally rooted.
2. Venture capital investors look for a higher return from non-local investments. There is therefore a trade-off between the lack of geographical proximity and the need for a higher return rate to compensate for additional risk.
3. Investors that are less actively involved in their investments will be less concerned with investing in ventures that are geographically close.

Source: Avdeitchikova 2005

Therefore, when you don't invest locally or actively, deals are not proprietary, you need a higher return because of extra risk and you're too far away to get involved. Alternatively if you invest locally you social network will provide you proprietary deal flow, your risk is lower and you can get more involved in your investments.

Conclusion

Venture capital is a regional business best executed within a cluster. Where VC firms are located is important to entrepreneurs because VC's provide money and much more. VC's invest in firms when risks are high, information is scarce, markets are new and well motivate people are key. VC firms stage their investments over time, monitoring their investments and repeatedly revaluating them. VC's are involved in their investee firms through boards, management contracts, informal advice and assistance with additional rounds of financing and exists. The cost in time and expense of providing this intensive involvement at a distance is large (Chen et al 2009).

> "The ability to monitor the portfolio company, to coach the management team, and to provide introductions, may depend upon the ability to interact frequently with the company" (Chen et al 2009, page 1).

Doriot described a successful VC as: "They have a gambler's nerve, a fortune-teller's insight and a prospector's nose for gold" (Ante 2008, page 252). At a tribute to him after

his death the following lessons from Doriot were shared, and they all speak to the importance of the successful VC being involved in the investee company and its issues:

1. Problems should not be ignored or avoided, but confronted. From problems and challenges we can learn and grow.
2. Products are less important than ideas, and ideas are less important than people. People define an organization.
3. A commander leads by action.
4. Have the capacity to get through to the core of an individual.

Source: Ante 2008, page 258.

One can only get through to the core of an individual through strong personal relationships, build over time and face-to-face. Stross (2006) asks why relationships must be in person. In our internet and mobile telephone world, why do people still need to get together? His prominent VC "scoffed at the suggestion of virtual meetings as a feasible medium of establishing trust in business. He said that if the matter were important — and human beings were involved — he believed that there would never, ever be a replacement for face-to-face meetings" (Stross 2006). Porter (1990) describes personal interaction in a cluster as "the social glue" that binds a cluster together providing information, accessing resources and assisting with execution. A cluster is built around "personal relationships, face-to-face contact, a sense of common interest, and insider status" (Senor 2009, page 197). Knowledge, team work, a desire to win, networks, collaboration, and a VC nearby that is willing to dare are the keys to a successful cluster and to entrepreneurial firms to my mind.

I have chosen to locate most of my venture capital activities in Mississauga, Canada's sixth largest city, to the west of Toronto, Canada's largest city. I have excellent relationships because of my corporate involvement and my volunteer involvement as the co-chair of the Mississauga Summit. Mississauga is a center for life sciences and high tech companies. I have social capital here, and proprietary access to deal flow. People ask me why I don't go to downtown Toronto to look for deals, or to Waterloo, a high-tech community (Research in Motion) an hour west, or to the U.S, and my response, even more so after researching and formulating this paper, is that Mississauga is my community, my sand box, and here I'll stay. I'll also look for deals where I can put both my financial capital and intellectual management capital to work. My professional venture capital investing approach is to "Think Active, Invest Local".

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