

Venture Capital Finance: Its Present Research Scenario and Prospects for the Future

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Abstract: *This paper reviews recent research results of the venture capital finance. The paper indicates that main contents of the theory are that how agency problems brought about by the information asymmetry through the contract design are solved and the value-added management service is provided. A number of empirical evidences provided by documents from some aspects such as the fund raising and the selection of the organization pattern, the project selection as well as the investment contract arrangement, post-investment management activities, withdrawal mechanism as well as the performance and so on are investigated. Problems in the research and possible research directions in the future are also discussed.*

Keywords: *Venture capital, venture capitalist, entrepreneur, asymmetric information.*

1 Introduction:

The birth and growth of new enterprises is the source of the economic development of a country. Since the foundation of the American Research and Development Corporation (ARD) which was the first formal venture capital institution in 1946, as the investment and financing system innovation, the venture capital had played an important role in some aspects such as supporting entrepreneurial activities of enterprises, promoting the development of strategic emerging industries, improving the efficiency of resource allocation and so on which can improve the whole competitiveness of the economy. The equity investment can be conducted towards unlisted entrepreneurial enterprises with the high-growth potentiality by the venture capital and the value-added management service is provided by the venture capital. A lot of innovative enterprises such as Microsoft, Apple, Google, Facebook, Alibaba, Baidu, Tencent, and the like have risen sharply in succession, and have profoundly changed the prospect of the world economy just because of the support of the venture capital.

2 Objectives of the study:

The overall objective of the study is to know the present research scenario of the venture capital with an emphasis on the relationship between venture capitalists and entrepreneurs. The specific objectives of the study are to explain the progress of the venture capital finance and problems associated with the venture capitalists and to find out the prospects for the future.

3 Methodology of the study:

The paper is prepared based on secondary data and it is descriptive in nature. The paper reviews recent gradually increasing theories and empirical research results of domestic and foreign scholars in the field. The paper indicates that main contributions and to-be solved problems can lay the phased research foundation for the newly-developing but the highly promising research field. Besides, the prosperity of venture capital research can be promoted. The structure of the remaining part of the paper is as follows: firstly, analyzed the theoretical basis and the operation mode of the venture capital; secondly, discussed the selection of raising and organization forms of the venture capital funds; thirdly, discussed the project selection of the venture capital investment and the arrangement of the venture capital contract; fourthly, discussed the post-investment management activity of the venture capital; fifthly, discussed the withdrawal mechanism and the performance of the venture capital; at last, concluded and forecasted the future research prospects.

4 The Theoretical Basis of the Venture Capital:

The pioneering companies have the typical characteristics, which are different from mature companies. Storey (1994) pointed out that in general, the equity capital gap exists in the growth process of the pioneering companies. The greater external financing restrictions exist in the early-stage innovative companies (European Commission, 2000). However, the higher uncertainty and the risk exist in the pioneering companies in the process of the exploration and the establishment in various aspects of the product, the technology, the market, the management and so on. Besides, the pioneering companies are in the shortage of “hard assets” which are available for the mortgage. The reputation has not been established by the historical record of the management so that the information transparency is lower, and the phenomenon of the information asymmetry is particularly serious (Sahlman, 1990; Murray and Lott, 1995; Zhang and Liu, 2000; Ueda, 2004). The “rational discrimination” in the aspect that the required funds provided by the bank is brought about by the above characteristics. The reason is that the financing risk and the transaction costs with high loans cannot be compensated by the bank through the raise of the interest rates because of the existence of the problems of the “adverse selection” and the “credit rationing” (Stiglitz and Weiss, 1981). Besides, the asymmetry of the income and risk exist in the bank with the credit form to support the pioneering companies. The objective requirements of the long-term effective capital with the “revenue sharing and the risk sharing” of the pioneering companies are not conformed to the credit funds with the debt and the time of the short period (Zhang and Liu, 2000). In addition, institutional restrictions are the main factors of impeding the bank to enter the capital market, such as the implicit control of the supervision organization towards the interest rate, the restrictions of the company shareholding right of the bank, the lack of the professional talents, the lack of the incentive plan of the human capital closely linked to the return of the projects and so on (Lerner, Leamon, and Hardyman, 2012). The entry threshold exists in the public capital market, which requires the companies to provide the operation records of the limited number of years and the performance standard to deliver the sufficient information so that the basic requirements of the effective capital market are met and the interests of the investors are protected. The problems of the equity capital gap of the pioneering companies in the early stage of the growth cannot be solved (Bhidé (1994). Chan (1983), Chan, Siegel, and Thakor (1990), Sahlman (1990), Winton and Yerramilli (2008) all pointed out that the venture capitalists have the comparative advantages in the aspect of solving the problem of the information asymmetry. Firstly, the venture capitalists have the special knowledge of the

technology, the industry and the market. As the informed investors, good investment projects can be selected by the venture capitalists under the circumstance of the information asymmetry. Besides, the strong supervision can be conducted after the investment. Secondly, some special governance mechanisms for solving the agency problems are developed in the practice, which contain the staged financing, convertible securities, joint investment, the participation of the board of directors, the performance compensation based on the value creation and so on. Gompers et al. (2016) Show that venture capitalists take decisions across eight areas are deal sourcing; investment selection; valuation; deal structure; post investment value added; exits; internal VC firm issues; and external VC firm issues (Shamim, 2022).

5 The Operation Pattern of the Venture Capital:

The venture capital companies are established by the venture capitalists who have the experiences of the company management, the industry knowledge and the investment operation. The funds are raised, the projects are selected, the investment contracts are arranged and the management activities are conducted after the investment by the venture capitalists so that the value-added benefits of the capital are obtained with the transfer of the stock equity withdrawal through the ways of the IPO, the merger and so on at last. The funds of the venture capital are mainly from the qualified investors of the large-scale institutions, wealthy individuals and the like with the patience, the ability of the high risk identification and the bearing ability because of the fact that the funds of the venture capital belong to the private equity investment and require the longer periods. The large-scale institutions contain the pension funds, the donated funds, the insurance companies, the banks and the industrial companies. The funds usually have the specific fundraising scale, the investment strategy and the operation period. 99% of the total amount is generally put into by the investors while remaining 1% is put into by the venture capitalists with their own funds. The investment scope can be the specific industries, the specific regions or the specific investment stage. In general, the operation period is 10 years. The problems of the adverse selection are solved in the project selection process. The information of the deal flow can be obtained by the venture capitalists through the wide range of the channels and network relationships. The basic information of the companies can be realized through the ways of the business plan, the private interviews and the like provided by the companies so that the decision whether to invest on the basis of the certain investment standard is made at last. The potential investment risks require the higher growth expectations for the compensation so that the vast majority of the investment projects which do not meet the standards are removed. The final investment proportion can be maintained at about 1%. The investment term sheet will be signed between the projects through the selection process and the venture capital, which contains the vast majority of contents of the formal investment contracts. Whether to invest will be confirmed by the venture capitalists. The formal investment contracts will be signed once the decision of the investment is made. The amount of the investment according to the stipulation of the contract will be put into the company account according to the appointed time. The operation of the companies can be supervised by the venture capitalist after the investment through the active management activities and the specific resources can be provided to help the companies grow rapidly so that the maximum of the prospective value can be realized.

6 The Raising of the Venture Capital Funds:

The empirical research of the venture capital funds raised mainly involves two aspects: one aspect is influencing factors and consequences of the raising fund, and the other aspect is differences of fund contract terms and reasons for the differences of the fund contract terms. Lerner (2002) analyzes periodic fluctuations of the venture capital market from the supply and demand point of view. He found that the short-term rigidity of the supplying curve is the main reason for affecting the periodic fluctuations of the market. Different from the open capital markets with the high fluidity which makes investors change easily the allocation of the funds, some factors that the interval time of raising new funds by the venture capital institutions is longer, the number of experienced investors is very difficult to increase in a short time, organizational challenges are faced with the enlargement of the scale of the management funds, the way of the reporting performance of the funds is conservative and the like bring about the slow adjusting speed of the supplying curve. The fund's self-clearing characteristics of the funds affect market cycle reversely. When the degree of the IPO or merger of the market is high, the fund supply should be increased. However, the investors have received plenty of the returning funds. Otherwise, it would be the opposite. The above research shows that the phenomena of the incomplete competition and the information delay exist in the venture capital market. Chakraborty and Ewens (2018) examine agency conflicts during venture capital fundraising it has impact on investment decisions. Groh, Liechtenstein and Lieser (2010) constructed a comprehensive index to measure the attractiveness towards the venture capital and private equity investors from the national level. According to the review of the documents, they confirm six key driving factors: the economic vitality, the capital market depth, the tax, the investor protection and corporate governance, the human power and social environment and the entrepreneurial culture.

7 The Organizational Form of the Venture Capital fund:

The partnership is the main organization form of the venture capital companies (Sahlman, 1990; Gompers, 1994; Hsu and Kenney, 2005). The governance mechanism of the limited partnership was analyzed by Sahlman in the classic document published in 1990. As the foreign goods, the venture capital industry in Bangladesh has the significant differences in the aspect of the organizational form. Adhikary (2009) believed that the venture capitalist market in Bangladesh of the present stage is not fully developed. The social credit condition and the legal environment are not complete but the venture capitalists will be professional and skilled in different lines of business and they put in their best efforts to run the applicant's business effectively, as they also own the investee firm. A systematic problem exists within the major segments of the financial system in Bangladesh in catering to the financing needs of entrepreneurs. Therefore, it is argued that the venture capital industry may be developed as an additional financial intermediary for catering to the financing and non-financing needs of the entrepreneurs as it can participate in the management of the investee firms actively and exercise the due diligence process when disbursing credits. Importantly, a unique feature of venture capital financing is that it addresses the funding needs of entrepreneurial companies that generally do not have the size, assets, and operating histories necessary to obtain capital from more traditional sources, such as public markets and banks (Venture Impact, 2004). Hu and Wang (2005) believed that the indirect pricing mechanism is formed by the limited partnership towards the human capital of venture capitalists so that the stimulation

problem of the venture capitalists is solved, which is the foundation of the institution of the success of the venture capital.

8 The Project Selection of the Venture Capital:

Some empirical evidences for referential use are provided by the empirical research documents. Amit (1998) pointed out that comparative advantages of the selecting and supervising the project of the investors of the venture capital are more prominent in the high and new technology industry with the significant information asymmetry. By using the questionnaire survey data of venture capital institutions, they found that the rate which the venture capital accounts for is higher in the industry with the higher degree of the information asymmetry. The bureaucratization is also the factor which affects the potential entrepreneurs to leave office and establish new enterprises. Kaplan, Sensoy and Strömberg (2009) investigate how the newly-established enterprises evolve into mature and complicated public companies by using the sample data of 50 companies with the venture capital. They find that the core business or business idea is generally very stable. However, part of the management team changes. Besides, the change of the management team of the company invested by the venture capital is greater than the change of the management team of the company without the investment of the venture capital. Accordingly, suggested that the investors of the venture capital should pay more attention to the investigation of the business not the management team when they choose investment projects. By using the data of 136 European venture capital institutions, Patzelt et al. (2009) find that the top management team with the higher proportion of the science or the engineering education background and more entrepreneurial experiences will have the tendency to focus on the early-stage investment strategy. The proportion of the top management team with the higher proportion of the management education background to implement the diversified investment strategy of the industry is greater. The top management team with more international study or employment experiences has the tendency to invest in broader geographical areas.

9. The Arrangement of the Investment Contract: The effective allocation of the residual control rights and the residual claim rights is very important in the investment field of the venture capital because of the information asymmetry and the incomplete contracts. The complete right of control is possessed by the venture capital in the aspects of the right of director, the voting right and the liquidation right when the company performance is bad. When the company performance is improved, the entrepreneurs obtain more rights of control. The cash flow right is reserved by the venture capital while the vast majority of the rights of control and the liquidation rights are abandoned when the company performance is good. Besides, the behavior of leaving the company is restricted by the terms of the competition prohibition and the share cash terms contained in the contract so that the "lock-in" problem is solved. The share cash terms are more common when the stage of the financing is earlier and the "lock-in" problem is more serious. The relationship between the stock right compensation and the performance of the entrepreneurs is more sensitive when the problems of the agency by agreement and the information asymmetry are more serious. Yao, Wang and Cheng (2011) are the only original documents to study the contract terms of the VC investment at present. They summarize the scale of the relationship between the setting motivation of the terms, the setting of the terms, the effects of the terms, the setting motivation and the setting relationship of the terms, the setting of the terms and the effect relationship of the terms according to the content encoding and the data superposition of the information of the interviews of the 3 cases. They find that the term settings are driven by the information asymmetry, the uncertainty and the

new entry defect. The management participation is the most important term setting. The management participation is related with all setting motivations and has the most comprehensive effect towards the invested companies. The management participation is the core link of the effect of the setting motivations towards the terms. Besides, the term settings have the effect on the operation of the companies, the company strategy and the company governance. The aspect of the operation is mainly reflected in the term settings.

9 The Supervision Function of the Venture Capital:

Tian (2010) found that the investment amount of every round is lower when the venture capital institutions are distant from the invested enterprises, rounds of the investment are more and the time interval of every round is shorter. Zhang and Liao (2011) find that the profit management level before the listing can be significantly reduced by the venture capital with the long time limits of the investment. However, the profit management level has been significantly improved by the venture capital of the short period of the time before the listing. Wang and Zhang (2012) find that the salary-performance sensitivity of the layer of the executives of the listed companies invested by the venture capital is higher than the listed companies without the investment of the venture capital. The salary-performance sensitivity of the listed companies is higher when the proportion of the shareholding of the venture capital is higher, the investment term is longer and the number of the venture capital institutions invested by the companies is more. Jia and Li (2011) find that the underpricing level of the first day of the companies supported by the venture capital is significantly higher than that of the companies without the support of the venture capital. The long-term performance is also significantly lower after the listing of the companies invested by the venture capital. The further study shows that the cautious investment strategy which the foreign venture capital tends to is reflected when proportion of the shareholding of the largest shareholder in the company supported by the foreign venture capital is lower, the scale of the board of directors is larger, the proportion of professional director is higher, the time of the foreign venture capital from the IPO is shorter, the rounds and the institutions are more and the proportion of the shareholding is larger.

10 Value-Added Services Function of the Venture Capital:

The growth of the enterprises invested by the venture capital is faster than the new enterprises without the investment of the venture capital whether before the acceptance of the investment of the venture capital or after the acceptance of the investment of the venture capital. Hochberg (2012) finds that compared with the companies without the investment of the venture capital, the earnings management of the companies invested by the venture capital is lower. The better market reaction exists in the companies invested by the venture capital when the stockholders' rights agreement (for example, the poison pill plan) is adopted. The proportion of the separation between the more external directors, the chairman and the general manager is greater. Krishnan et al. (2011) find that the reputation of the venture capital institutions is positively related to the post-marketing three-year-term performance of companies. The further research shows that the probability reserving stock and seats of the board of directors after the IPO of the venture capital institutions with the high reputation in three years is higher. Besides, the venture capital institutions with the high reputation are positively related to the three-year-term performance of the IPO of the companies, which shows that the long-term performance of the

IPO of the companies can be improved by the venture capital institutions with the high reputation through the continuous supply of good governance. Li (2008) finds that the support of the strategy, the human resource management, the follow-up financing and the relationship network resources are mainly reflected in the positive effect by the venture capital towards the company performance. The external financing environment can be improved by the venture capital institutions with the high proportion of the shareholding, the high reputation, the joint investment or without the state-owned background so that problems of the insufficient investment of the companies with the shortage of the cash can be relieved. More short-term debts can be obtained by the state-owned venture capital institutions.

11 The Withdrawal Mechanism of the Venture Capital:

When the value is low in the open capital market, the private financing is dependent on the venture capital. The ability of choosing the time of the venture capital with long-time of obtaining the employment is stronger. Compared with the companies without the investment of the venture capital, the transaction amounts of the stocks and the abnormal returns of the companies invested by the venture capital are greater, which show that compared with the management layer and other stockholders, the stocks will be more actively sold after the day of lifting the ban by the venture capital. Li et al. (2003) show that the preference of venture capital companies towards the IPO is higher. The proportion of the stock right transfer in the practical withdrawal channel is the highest. The main problems that the trading market of the stock right is not developed, the policies and regulations are not sound, the growth enterprise market is not open and the intermediary agencies are lacking exist in the withdrawal of the venture capital.

12 Performance of the Venture Capital:

The whole performance of the funds is measured roughly according to the proportion through the IPO, the sale or the merger and the withdrawal in the fund portfolio investment companies by the empirical research. Hochberg et al. (2007) find that the proportion through the IPO or the sale and the withdrawal of the investment portfolio companies can be significantly improved. The companies invested by the venture capital with the establishment of good network relationships through the joint investment are more likely to survive to the next round of the financing or conduct the IPO and be sold at last. Establishing the relationship with the investors of the same industry who possess good network relationships is very important for any venture capital institution because more future reciprocal joint investment opportunities can be reproduced. Tian (2010) found that the probability of the IPO of companies is greater, the performance of the listed IPO companies is higher and the survival probability of the listing after three years when the venture capital institutions are far from the geographical position of the companies and the rounds of the financing are more. Chen et al. (2010) found that the proportion of the venture capital institutions and the invested companies concentrating in areas of San Francisco, Boston, and New York is high by using the data in America. Compared with other areas, the proportion of the withdrawal of the invested companies of the venture capital institutions concentrating in areas through the IPO is higher. Bottazzi et al. (2008) found that the venture capitalists with the experiences of the industry or the consulting industry will be more actively involved in employing managers, recommending

directors, helping the financing and visiting frequently the invested companies. Compared with the banks, companies and the affiliated venture capital institutions of the government, the company management activities will be more actively intervened by the private independent venture capital institutions. The active participation in the company management activities of the venture capitalists has the positive correlation with the fact that whether the IPO of the company can be realized or the company can be purchased. The follow-up fund performance has the significant positive correlation with the fund performance of the earlier stage, which shows that the fund performance is continuous. The possibility that the follow-up funds raised by the funds collected in the period of the brisk market declines, which shows that the fund performance raised in the period of the brisk market is worse. Hochberg et al. (2014) found that the performance of the venture capital institutions is continuous with the knowable hard information for the investors of the performance of the fund annual disclosure and the soft information only for the existing investors and the fund managers of the final performance of the end period of the management of the funds. The continuity of the performance of the venture capital institutions means that the performance of the former funds has the significant positive correlation with the performance of the follow-up funds. Compared with the external investors, the better decisions can be made by the existing investors and the lock-in phenomenon towards the fund managers can be formed. The realization of the balance between supply and demand of the fund managers through raising fund fees can be prevented so that the performance of the funds of the good venture capital institutions can be sustained. Hochberg and Rauh (2012) found that compared with other institutional investors, the redundant funds are allocated in the local area by the public pension funds. Besides, the performance level is reduced by the allocation. The authors believe that this is possibly related with the low management ability of the public pension funds and the political pressure requiring for the investment in the local place. Nanda and Rhodes-Kropf (2017) believe that frictions occurring when venture capitalists with differing objectives work together in syndicates. Entrepreneurs must be careful about selecting and building the syndicate of venture capitalists who back their firm.

13 Conclusions:

As the institutional innovation of the collective investment, the projects can be selected and the value-added services are provided by the specialized knowledge of the venture capitalists. Besides, the special governance mechanism can be developed so that the problems that the agency by agreement and the contract are not complete are solved. The change of the supply and demand and the insufficient competition are the main reasons for affecting the differences of the periodic fluctuation, the fundraising and the contract terms of the venture capital. The venture capitalists tend to choose the industry and the companies with the high information asymmetry so that the competitive advantage is established. Besides, the complementary information is obtained with the wide application of the joint investment and the selected range of the projects is extended. The intensity of the supervision is affected by the seriousness of the agency problems and the cost of the supervision. The product development of the companies, the increase of the employees, the professionalization of the management, the technological innovation and the company governance can be promoted by the venture capital and the performance of the companies can be promoted at last.

14 Future Research Prospects:

As the emerging field, the significant progress has been made by the venture capital in the aspects of the theoretical and the empirical research. However, some deficiencies still exist, which require to be expanded and improved in the future research. The presentations are the following:

Firstly, the choice of the financing of the pioneering companies is various. The existing research still lacks clear theoretical explanations and empirical evidences. The mutual competition and the complementary effect between different channels of the financing can be tested by the systematic and authentic database in the future.

Secondly, some problems exist more or less in the data of the existing empirical research documents. Even though the commercial database is established by the system, the omissions and the misrepresentations exist in the commercial database because of the privacy of the transactions of the venture capital. How to deal with the selection and treatment effects are still problems of many existing researches.

Thirdly, the effects of the venture capital has played in the process of the IPO of the companies are investigated by a number of the documents. The documents researching the effect of the final withdrawal of the venture capital towards the companies after the IPO of the companies are still scarce. More data should be collected to expand the research.

Fourthly, differences which exist in the contract terms in different legal and institutional environments are indicated by some documents. More private information of the transaction contract between the investors and the venture capital as well as between the venture capital and the invested companies should be obtained in the future.

Fifthly, the empirical researches with other dimensions (like the differences of the joint investment with the state-owned background, the privately operated background and the foreign capital background in the aspects of the fund raising, the project selection, the investment arrangement, the management after the investment and the withdrawal) are scarce so that the empirical research based on the institutional background is required in the future.

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