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## Critical Factors in the Negotiation Process between Private Investors and Entrepreneurs

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**ABSTRACT**

The purpose of this research is to investigate how private investors and entrepreneurs act and reason in a negotiation process and to identify critical factors and study how these are handled. The research is a qualitative study performed as an explorative case study based on ten semi-structured interviews with both investors and entrepreneurs. The analysis is conducted by applying a number of different theoretical perspectives. Within the developed theoretical framework, the main theory applied is the Agent-principal theory to explain how information asymmetries existing in the process are critical for the negotiation. This theory is furthermore complemented with theories of trust and power. The conclusions drawn are that the majority of critical factors can be explained due to information asymmetries. The result further supports that trust is identified to be the most important critical factor, both having a substituting and complementing role to the other theories. The paper further sums up with a presentation of recommendations for practical improvements. When these factors are identified in advance, the ambition is that these can facilitate for a less complex and ambiguous negotiation process in the future.

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## PREFACE

To begin, we would like to express how this bachelor thesis has been a great opportunity for us to sum up our bachelor studies in Business and Economics at the Stockholm School of Economics. This study has provided us with a deeper understanding for the interesting sides of either being an investor or an entrepreneur and furthermore given us the opportunity to meet inspiring and interesting people. We have gained knowledge about the dynamics of the venture capital and private equity industries as well as about the challenges facing entrepreneurs.

Moreover, we would like to thank the persons who have made this bachelor thesis possible and enjoyable. Firstly, we would like to thank our supervisor, Peter Norberg, Ph.D. at Center for Management and Organization at Stockholm School of Economics for guidance during the process of writing this thesis. Secondly, we would like to thank Rasmus Westholm and Max Sihvonen for their feedback and interesting inputs during the thesis work. Furthermore, we would like to thank all the respondents, for their willingness to participate in this study and making it possible. They have all shown interest to answer our questions and provided us with invaluable insights, which constitutes the essence of this study.

We hope this study will be valuable for all interested in the area of negotiation processes and furthermore valuable for both entrepreneurs and investors for future good negotiations and partnerships.

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## TABLE OF CONTENT

1. INTRODUCTION .....	6
1.1 Background .....	6
1.1.1 Purpose .....	7
1.1.2 Research Questions .....	7
1.2 Delimitations .....	7
1.3 Previous Research .....	8
1.3.1 The Negotiation Process .....	8
1.3.2 The Relationship Between Investors and Entrepreneurs .....	8
1.4 Research Gap .....	9
1.5 Structure of the Remainder of the Study .....	10
2. METHODOLOGY .....	11
2.1 Scientific Approach .....	11
2.1.1 Research Paradigm .....	11
2.1.2 Qualitative Research .....	12
2.1.3 Abductive Approach .....	12
2.2 Case study .....	13
2.3 Methods and Research Design .....	14
2.3.1 Data Collection .....	14
2.3.2 Literature Review .....	15
2.3.3 Interviews .....	15
2.3.4 Reflection and Critique of Method and Research Design .....	17
2.4 Analysis of Data .....	18
2.5 Justification for Choice of Methodology .....	19
2.5.1 Reliability .....	19
2.5.2 Validity .....	19
2.5.3 Generalizability .....	19
3. THEORETICAL FRAMEWORK .....	20
3.1 Theoretical Approach .....	21
3.2 Information Asymmetries .....	21
3.2.1 Agent-principal Theory .....	21

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3.3 Trust.....	26
3.3.1 What Is Trust?.....	27
3.3.2 Implications of Trust.....	27
3.3.3 Trust as a Complement or Substitute .....	30
3.4 Power.....	30
3.4.1 What Is Power?.....	30
3.4.2 Implications of Power .....	31
4. EMPIRICAL FINDINGS .....	32
4.1 Presentation of Actors.....	32
4.1.1 Investors .....	33
4.1.2 Entrepreneurs .....	34
4.2 Definition of the Negotiation Process.....	35
4.2.1 Negotiation Process in Venture Capital Firms .....	36
4.2.2 Negotiation Process In Private Equity Companies .....	37
4.2.3 Crucial Points to Agree Upon.....	37
4.2.4 Valuation Methods .....	38
4.3 Strategy For the Negotiation Process .....	38
4.3.1 Evaluation Criteria.....	39
4.3.2 Influential Factors In the Partnership .....	40
4.3.3 How the Negotiation Process Influence the Forthcoming Collaboration...	41
4.4 Formulating An Agreement.....	42
4.5 Problems Arising In the Negotiation Process.....	44
5. ANALYSIS .....	46
5.1 Analysis of Information Asymmetries.....	46
5.1.1 Adverse Selection .....	46
5.1.2 Moral Hazard .....	47
5.1.3 Agency Costs .....	49
5.2 Analysis of Trust .....	50
5.2.1 Perceptions of Trust.....	50
5.2.2 Implications of Trust In the Investor – Entrepreneur Relationship .....	51
5.3 Analysis of Power .....	52
5.4 Further Reflections.....	53

6. CONCLUSION .....	55
6.1 How Do Investors and Entrepreneurs Reason and Act in the Negotiation Process? .....	55
6.2 What are the critical factors in the process and how are these handled?.....	55
6.2.1 Information asymmetries.....	56
6.2.2 Trust.....	56
6.2.3 Power.....	57
6.3 What Areas of Improvement Exist in the Negotiation Process? .....	57
6.3.1 From the Perspective of an Investor .....	57
6.3.2 From the Perspective of an Entrepreneur .....	58
7. DISCUSSION.....	59
7.1 Discussion of Conclusions .....	59
7.2 Contribution to Knowledge.....	59
7.3 Limitations of Conclusions .....	60
7.4 Suggestions for Further Research .....	61
REFERENCES .....	62
APPENDIX.....	65
1. Definition of Negotiation Process.....	65
2. Interview questions .....	69

# 1. INTRODUCTION

In this introductory chapter the background to the area which leads to the purpose and research questions will be presented. Furthermore will the delimitations, previous research, research gap and structure of the remainder be presented.

## 1.1 Background

Sweden is the country in Europe that attracts most venture capital financing relative to size according to Reuters (Affärsvärlden, 2013-02-05).

However, there is an on-going discussion in the media about the lack of capital for innovators and entrepreneurs who are struggling to develop their business ideas due to limited financing options. The critics' claim that private investors often act short term and take advantage of their position to earn profits quickly (Svenskt Näringsliv 2012-02-28).

What seldom is portrayed is how venture capital and private equity actors actively invest and support high potential companies in existing industries as well as creating new innovative enterprises. Core values within the industries are not only to make profit investments, but also to sustain growth and support innovation, which contributes to job creation across Sweden. Companies such as Microsoft, Skype, Spotify and Intel, are some, just to mention a few of all successful companies financed by risk capital (EVCA, 2013-05-08).

The importance of negotiation in an acquisition is an invaluable component in any great forthcoming partnership. Venture capital and private equity investments are often long lasting, and the negotiation can have a significant impact of how to avoid conflicts and improve the relation among the parties. For entrepreneurs it is essential to negotiate for a reasonable valuation of their company and how future decisions will be made, in order to decide the amount of equity and influence the investors will have. Hence, structuring the deal is a key aspect of completing a round of financing for an entrepreneur, and it is crucial that both investors and entrepreneurs are satisfied with the company under its new capital structure. As a result, negotiation and structuring the deal can be the most complex aspects of the investment (Capital Education Foundation, 2013-05-07).

Extended previous research is compiled within the fields of negotiation and investor-entrepreneur relation separately, but little is done on the intersection of these two fields of research. Hence, this paper will further investigate this intersection.

### 1.1.1 Purpose

The purpose of this study is to identify the critical factors in a negotiation process between entrepreneurs and private investors, in order to reduce complexity and ambiguity.

### 1.1.2 Research Questions

In order to fulfil the purpose the study aims to answer the following research questions:

- How do investors and entrepreneurs reason and act in the negotiation process?
- What are the critical factors in the process and how are these handled?
- What areas of improvement exist in the negotiation process?

## 1.2 Delimitations

In this study the negotiation process between entrepreneurs and investors has been studied. Investment criteria are most often regarded as the one of the first step in the negotiation process between an entrepreneur and investor. But, within this study a more thoroughly investigation regarding the investment criteria has been excluded. Investment criteria has been investigated in a much greater extent compared to the subsequent phases in the negotiation process and hence has this research focused on the later stages of the negotiation process.

A second delimitation of the study is that it is geographically limited to the Swedish market and furthermore limited to private investors in venture capital and private equity firm and hence will neither concern institutional investors nor business angels.

This study has a more holistic approach to the negotiation process in order to condense more general factors which contributes to a successful negotiation process and hence do not aim to map technical details within the negotiation process.

## 1.3 Previous Research

This section will map the previous research within both the negotiation process and the relationship between investors and entrepreneurs.

### 1.3.1 The Negotiation Process

There is a vast amount of literature written within the field of negotiation and it is possible to distinguish three distinct types of school. First is the historical school with its roots from the European diplomatic tradition from the 17th and 18th century, but which also relates to the some of the most prominent philosophers during the antiquity and renaissance. The second school has been developed during the past twenty-five years where the field of negotiation has been mostly influenced and dominated by American researchers. The third school consist mainly of the French negotiation researchers whom have contributed with a more nuanced understanding and furthermore a European application of the American models and theories that are standard today (Lempereur et al, 2012).

Previous research regarding the negotiation process has interpreted the process in different ways; some has focused on the different steps in the process while other studies are concerned with negotiation tactics or other behaviours as problem definition and information processes in the negotiation process (Agndal, 2007). In this study the different steps in the negotiation process has served as a foundation for initially constructing relevant interview questions (see Appendix 2) but the focus then gradually shifted towards focusing more on the interaction.

### 1.3.2 The Relationship Between Investors and Entrepreneurs

Previous studies of the relationship between investors and entrepreneurs have shown that co-operative relationships between private investors and entrepreneurs are necessary for the success of investor backed start-ups and some studies may even say that the relationship is even more important for success of the business than the capital itself. However, even though it appears that co-operation creates benefits for both parties it does not characterize all relationships. The funds being used by the entrepreneurs are more costly for the investor than the entrepreneur and hence there is an incentive for the entrepreneur to not be co-operative. There is also

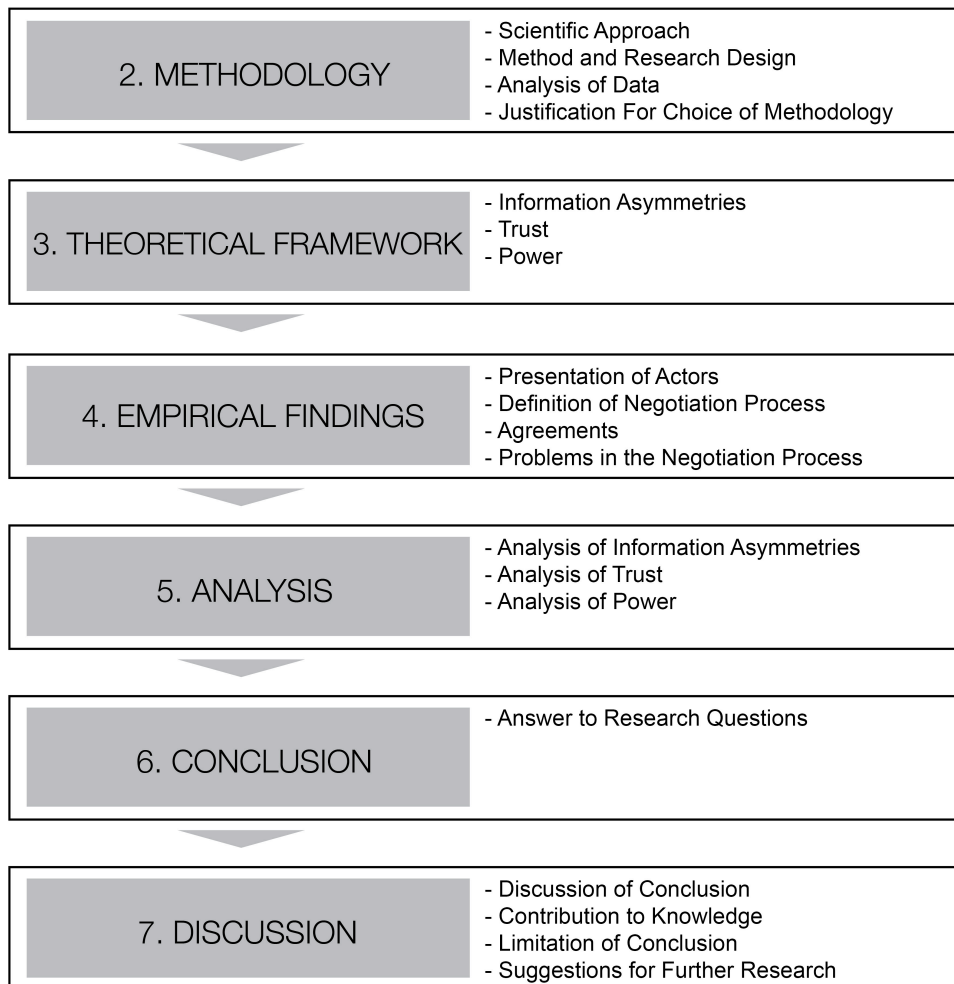
an incentive for the investor to behave opportunistic on expense of the co-operation by pressure the entrepreneur to seek short-term profits on behalf of long-term profitability and also to harvest a venture rather than reinvest in the ventures future products and development. Previous studies focused in a greater extent on various control mechanisms in order to maintain a functional relationship. But this has been further researched, and where both control and trust were found to be needed to be considered simultaneously in order to understand the investor-entrepreneur relationship. (Shepherd & Zacharakis, 2001). More recent studies have furthermore shown that the relationship between investors and entrepreneurs is in a great extent constructed on social exchange and trust (Yitshaki, 2008).

## 1.4 Research Gap

Within the literature there has been relatively much written regarding the negotiation process and also about the relationship between entrepreneurs and investors. However, there is not much written about the intersection between these two fields of study, i.e. the negotiation process between investors and entrepreneurs. There is little written about what the most critical factors are within the specific context of negotiations between investors and entrepreneurs and hence of interest to investigate this further. The study aims to bridge the gap between these two research areas and contribute within a Swedish context.

## 1.5 Structure of the Remainder of the Study

The structure of the remainder of the study is presented in figure 1 below.



**Figure 1.** A visualisation of the remaining part of the study.

## 2. METHODOLOGY

In this section the methodology, methods and approach to the study will be presented. The research has been performed as a qualitative study consisting of semi-structured interviews with both investors and entrepreneurs.

### 2.1 Scientific Approach

This study takes a more interpretative approach and was conducted as a qualitative research. This will be more thoroughly explained in this section.

#### 2.1.1 Research Paradigm

Interpretivism was developed as a result of the lack of meeting the needs from social scientists. The main critique against positivism was that it is impossible to separate people from the social context they act within. The implication of this is that the investigation of social reality also has an effect on. This means that the social reality is subjective rather than objective and shaped by our perceptions of it, which is also the premise this study is based upon. (Collis & Hussey, 2009)

Taking a stance from above this study takes a more interpretative approach. Within the interpretative paradigm there is a focus on exploring the complexity of social phenomena rather than the positivistic focus on measuring social phenomena. Where positivists use quantitative methods interpretivists adopt a range of methods that *'seek to describe, translate and otherwise come to terms with the meaning, not the frequency of certain more or less naturally occurring phenomena in the social world'* (Collis & Hussey, p.57, 2009)

An interpretive paradigm is suitable since the study aimed to condense critical factors from the interviews and in order to do so the research has been performed with an explorative approach. Furthermore the method is suitable to understand phenomena both from the researchers' and participants' perspective. (Collis & Hussey, 2009)

### 2.1.2 Qualitative Research

When there are few previous studies done on the studied area a combination of an explorative approach and a collection of qualitative data is appropriate. Qualitative research allows the researcher to get a more rich in detail and nuanced capture of our studied phenomena. In order to fulfil the purpose of identifying critical factors in the negotiation process, collecting qualitative data in nominal form will be the most suitable approach to answer the research questions. Performing a quantitative research would have implied a collection of quantitative data in numerical form and consequently disregarded the nuances and details that are possible to capture within a qualitative approach. A drawback with performing a qualitative study compared to a quantitative study is the possibility to generalize the results. Generalizability is the extent to which one can come to conclusion about a certain situation based on information about another. However, under an interpretative approach findings are generally allowed to be generalized from one setting to another similar setting. (Collis & Hussey, 2009) Using data triangulation, which in our case could have been a complement of quantifying our qualitative data and iterating this back to the respondents, is a way of increasing the generalizability and also the validity of the study. Due to the time frame of this study it was unfortunately not possible to conduct.

### 2.1.3 Abductive Approach

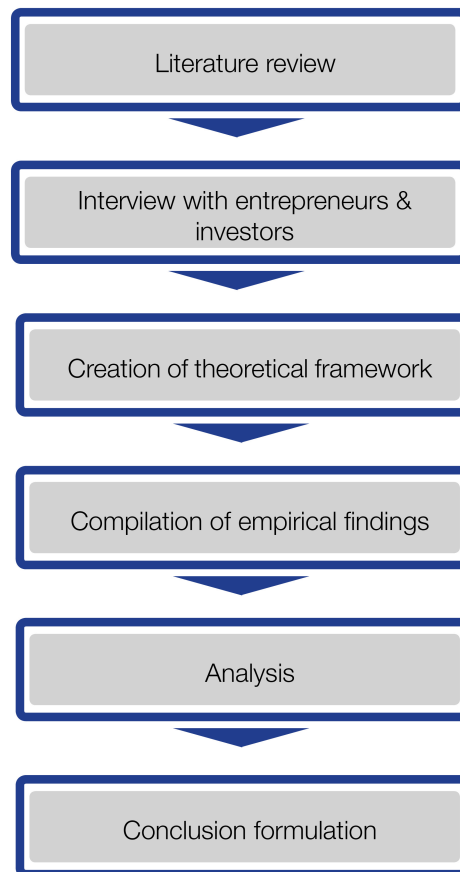
Since the study aims to condense critical factors in the negotiation process with help from an explorative approach and qualitative interviews and where an interpretation of actual situations leads to both empirical and theoretical understanding, an abductive approach is suitable. In accordance with this approach an alternation between theory and empirics has been performed throughout the analysis of the data. When conducting a case study this approach is especially suitable, since a case study aims to provide understanding of underlying patterns in a specific setting which targets a particular phenomenon and henceforth reduces the risk of a single-minded understanding. (Alvesson & Skoldberg, 2008)

## 2.2 Case study

Within an interpretive approach a case study is a commonly used methodology. A case study is suitable when one wants to explore a single phenomenon in a natural setting and the investigator has little or no control over events. In a case study the importance of context is essential. Since the study investigated the negotiation process in a real life context, the choice of a case study is appropriate in this case. A case study can be either descriptive, illustrative, experimental or exploratory. This study can be defined as an exploratory case study, since existing theory is used to understand and explain what is happening in the negotiation process between investors and entrepreneurs. (Collis & Hussey, 2009)

## 2.3 Methods and Research Design

The research was a qualitative study performed as an explorative case study based on ten semi-structured interviews with both investors and entrepreneurs. In figure 2 is a visualisation of the methods and research design.



**Figure 2.** Visualisation of the methods and research design.

### 2.3.1 Data Collection

The primary data used in this study consists of the ten interviews performed. The interviews have been performed in a semi-structured manner with five investors and five entrepreneurs. After conducting all interviews the information from the interviews were used in an iterative analysis process, where the empirical findings were analysed with help from the theoretical framework. In order to receive a holistic perspective on the negotiation process the respondents were selected due to their

beforehand researched perceived complementary experience. The primary data was used in order to ensure high quality of the data.

The secondary data was collected in order to complement the primary data. Furthermore it was used to create a theoretical framework, which was used to take a stance from when analysing the primary data.

### 2.3.2 Literature Review

The secondary data used in order to perform a literature review was collected from several sources as: the library of Stockholm School of Economics, Internet, online databases, newspapers and other media. To find relevant articles the following databases were used: Google Scholar, JSTOR, Scopus and Cambridge Journals. Frequently used key words were: investor, entrepreneur, negotiation, power, trust and agency theory.

The literature and scientific articles were furthermore studied in order to create an understanding of the negotiation process and the different aspects of it. There is a vast amount of literature written regarding the negotiation process, but not especially much regarding specifically the negotiation process in the intersection between investors and entrepreneurs. Hence, the ambition with the literature review was to create an understanding of what is thoroughly studied and what is not, and fill this gap by addressing a relevant research question and answer it with help from our empirical findings.

The literature review fulfilled two purposes, firstly to provide the authors with an initial understanding of the studied area in order to prepare interview questions and secondly to create a framework which the empirical findings could be analysed within.

### 2.3.3 Interviews

The interviews were held in a semi-structured manner with ten respondents; five investors and five entrepreneurs and carried out with an explorative approach in order to accumulate knowledge from each interview to get an as comprehensive understanding of the negotiation process as possible. Semi-structured interviews

were appropriate in this study since it is a suitable method to use when the aim of the study is to develop an understanding of the respondent's 'world' and it is necessary to understand the construct the respondents use as a basis for his or her opinions and beliefs about the particular situation. Furthermore it is suitable when there is a wish to follow up interesting side tracks derived from the respondents' replies.

The respondents were chosen with respect to their on beforehand perceived competence and experience within negotiations and can be studied in figure 3 below.

Interview Object	Position	Date
Investor 1	Senior Partner Private Equity Firm	2013-03-11
Entrepreneur 1	Founder	2013-03-11
Entrepreneur 2	Founder	2013-03-12
Investor 2	General Partner Venture Capital Firm	2013-03-12
Investor 3	CEO Venture Capital firm	2013-03-14
Investor 4	Global Head of Venture Capital firm	2013-03-22
Entrepreneur 3	Founder	2013-04-10
Entrepreneur 4	Founder	2013-04-10
Investor 5	Partner and Investment responsible in Private Equity firm	2013-04-12
Entrepreneur 5	Founder	2013-04-12

**Figure 3.** A description of the interview objects.

A more thorough description of the respondents, including background and knowledge areas can be found in the section *4.1 Presentation of Actors*. All the investors hold senior positions and are experienced negotiators. They were furthermore selected regarding the stage of a venture they normally decide to invest in. The respondents have a range from very early investing (i.e. seed capital), to somewhat later in the investment phase (i.e. venture capital) up to more investing in more mature companies (i.e. private equity). The entrepreneurs were selected primarily on their researched and perceived experience within negotiation with investors. All interviews were about one hour and held with both authors present and furthermore recorded and transcribed.

The interview questions were constructed with help from the literature regarding the negotiation process. Also the theoretical approaches used in study were incorporated, but in a more implicit manner. The question formulary can be studied in Appendix 2. The interview questions served as a base and support during the interviews. A great part of the discussions during the interview originated in follow up questions.

### 2.3.4 Reflection and Critique of Method and Research Design

To summarise the interview experience, it was extremely rewarding to interview such knowledgeable respondents. For the study it has been very beneficial with the semi-structured interview approach, since it has been a good balance between structure and openness. The built-in flexibility in the research design provided the authors with the possibility to adapt the questions to respective respondent, which enhanced each interview. If doing the research once again, it is very probable that the same research design would be used. However, an iteration of all the respondents answer with a more quantitative approach, as for example a survey would probably have benefited the reliability of the study. But due to the time frame, there was unfortunately not possible to conduct this.

When conducting a qualitative study within an interpretive paradigm, the consequence of our choice of method and our presence during interviews further has an effect on the research and the findings. It is per definition impossible not to affect the area one study, but hence of great importance to be aware of the fact that the researchers also affect the study.

There are always risks when basing an analysis on interview answers. One risk is that some answer might be given a higher or lower weight in the analysis, since the authors might interpret the transcribed interview in a different way. In order to reduce this, many follow-up and check-questions were asked during the interviews to ensure as little misunderstanding as possible.

Moreover, the study would probably have benefited of more respondents. Nevertheless, the authors noted repetitive answers during the last interviews, which

can be interpreted as a sign of an academic saturation. And relatively to the time constraints the authors believe that ten respondents provided enough qualitative data to analyse.

Regarding the secondary data, there are limitations with the literature review since most of the articles are international and hence their applicability to a Swedish context might be questioned.

All of the interviews has been held in Swedish and furthermore been transcribed mostly in Swedish. This has made the study bi-lingual and some of the data has been translated from Swedish to English. The authors are aware of the risks when translating from one language to another and the implications of writing the thesis in English, which is not the mother tongue of any of the authors. In order to reduce eventual losses of nuances and other translating errors, the authors have actively kept this in mind for being able to reflect the interviews in the most possible accurate way. Furthermore, the authors are of the belief that writing the thesis in English and all possible derived drawbacks from that outweigh writing in Swedish.

## 2.4 Analysis of Data

The analysis is based on both the empirical findings and the theoretical framework. From the empirical findings, the most influential factors in the negotiation process were extracted to be compared and analysed within the theoretical framework. In the analysis both congruent factors and gaps were identified and explained relatively to the theoretical framework, for being further analysed and henceforth derived to a conclusion.

The data was analysed by the author both together and alone, in order to progress through discussion but at some stages not influence each other. The analysis has been derived in two ways. On one hand by first studying the important factors that were stressed in the theory and identify these in the empirical findings. On the other hand the opposite way was also used, starting with condensing and extracting the interesting parts in the empiric and then match these within the theoretical framework. This has been done simultaneously in order to extract most possible and obtain a comprehensive analysis and conclusion.

## 2.5 Justification for Choice of Methodology

The use of more than one theory or various theories is called triangulation of theories and aims to reduce bias in the result. In this study a triangulation of theories has been performed, where the empirical findings has been analysed within both contrasting and complementary theoretical approaches. Triangulation is valuable since it enhances both validity and reliability of the study (Collis & Hussey, 2009).

### 2.5.1 Reliability

Reliability refers to the absence of differences in the results if the research was repeated (Collis & Hussey, 2009). Since the authors had an influence on the interviews in this study, it is not possible to redo the study with the exact same results and thus is the reliability of less importance in this study compared to validity. Consequently has the emphasis in this study been on authenticity and richness in the results rather than replication.

### 2.5.2 Validity

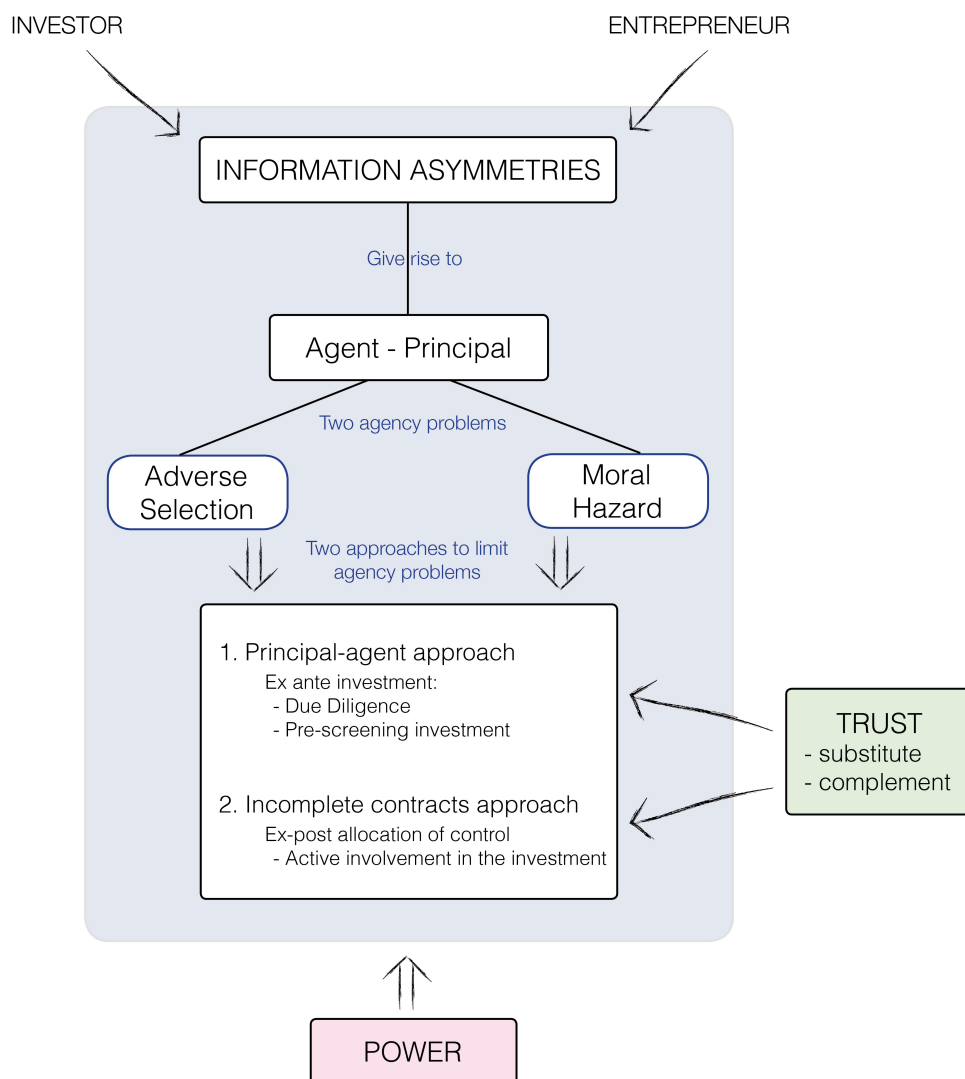
Validity is the extent to which the research findings accurately reflect the phenomena under study (Collis & Hussey, 2009). Since the aim was to receive rich and authentic information from the interviews, validity has been of great importance. In order to receive highest possible reliability has the interviews been recorded and the interview questions been adapted to the specific context. Furthermore through asking clarifying questions the obtained information has been validated.

### 2.5.3 Generalizability

Another concept worth discussing is generalizability of the methodology and methods. To perform an explorative qualitative study with semi-structured interviews could be useful when investigating other unknown and complex phenomenon as well. The approach of firstly create an understanding for how the activities are performed by reading relevant literature and articles within the area in order to create an understanding for the challenges and best practices and from that secondly find problems, improvements and critical success factors could be used by others as well.

### 3. THEORETICAL FRAMEWORK

This section will describe the theoretical framework used in this study, which is presented in figure 4 below. The main theory that will be applied is the agent-principal theory to explain how information asymmetries that exist in the process are critical for the negotiation process. This has furthermore been complemented with theories of trust and power.



**Figure 4.** A visual presentation of the theoretical framework used in the study.

### 3.1 Theoretical Approach

To be able to identify critical factors for an improved negotiation process between investors and entrepreneurs we have chosen to address the question within the theoretical framework of agency theory. When entrepreneurs have more information about an investment opportunity than the investors who are about to fund the venture, information asymmetries arise. The agency theory addresses approaches how to mitigate these information asymmetries between investors and entrepreneurs. However, in congruence with the abductive approach of this study, two complementary theories have been used to complement the parts in the empirical findings that could not initially be understood by agency theory. Hence, in order to create a more comprehensive explanation trust and power theories will also be applied.

### 3.2 Information Asymmetries

This study undertakes the implications of the information asymmetries that are present in the negotiation process between the entrepreneur and investor. The study will examine how these information asymmetries and problems are addressed in the negotiation process with help of agent-principal theory and this section will describe the approaches used to mitigate these information asymmetries.

#### 3.2.1 Agent-principal Theory

The agent-principal theory is based on the main principle that one party, (the principal) delegates work and responsibilities to another (the agent), who performs work on the principal's behalf (Jensen & Meckling, 1976). The principal-agent analysis approach, derived from the agent-principal theory, is a general framework used for analysing contracts, and is especially appropriate when risk and incomplete knowledge of actions are involved (Reid, 1999).

When an agent is contracted to make decisions in the principal's interest, information asymmetries exist between the parties. Information asymmetries can be described as certain pieces of information, that have significant impact on the firm's contract and that are only available for one party and not the other. This information plays a significant role if one party can use his/her information advantage for his/her own

advantage, rather than for the benefit of the firm and the principal. A number of problems can arise if it is difficult for the principal to ascertain whether the agent is abusing its advantage or not (Jensen & Meckling, 1976). In a negotiation process between a private investor (potential principal) and an entrepreneur (agent), this may arise and affect the deal outcomes, if one of the parties has significant more information than the other.

### Agency Costs and Problems

Since an agency relationship consists of individuals with differing preferences trying to engage in co-operative effort, contracts are employed to limit the agency costs that may arise. The level of agency costs depends on several factors, such as governmental laws as well as human ingenuity in devising contracts (Jensen & Meckling, 1976). Contracts are often implemented to define rights of the agent, performance criteria on which the agents are evaluated and the payoff functions they face (Fama & Jensen, 1983). These contracts aim to determine the most efficient contract for governing the relationship between the parties (Jensen & Meckling, 1976, Hart 1995a). Since there also are transaction costs involved in writing contracts, it is impossible to contract about all potential problems that may arise in a future collaboration between an entrepreneur and investor. Therefore, the negotiation process strives to emphasize the most important questions for both parties. Often there is a trade-off between the benefits from contracting and the cost of structuring, bonding and monitoring contracts among agents and principals with conflicting interests. The benefits have to exceed the costs to be profitable to contract (Fama & Jensen, 1983).

Often it can be more problematic to contract about the firm's human assets and not the material assets. This result in that problems associated with asymmetries of information can never be fully contracted away. Two primary causes of agency problems can result in 1) conflicts about alignment in different goals, 2) conflicts in deciding what an appropriate risk level for the company is. These conflicts often lead to two particular agency problems called *moral hazard* and *adverse selection* (Van Osnabrugge, 2000).

## Moral Hazard

Moral hazard occur when the agent not fully act according to the agreed contract (Fama & Jensen, 1983). A common example of this is when an agent runs the firm on a higher risk than agreed, because the agent is only making profit when the firm is making profit, but do not get affected if the firm runs bankrupt (Jensen & Meckling, 1976). This kind of agent-principal problem is more common in an employee situation than in an entrepreneur-investor relation. However, a moral hazard problem arising in the investor- entrepreneur relation is if the agent has personal incentives to hold information or act in another way than what is most beneficial for the principal. (Van Osnabrugge, 2000).

## Adverse Selection

Adverse selection on the other hand, refers to the misrepresentation by the agent regarding his/her abilities. One example is if the agent falsely claims that the company has certain resources or capabilities that the firm does not actually has after the investment. Adverse selection primary arises because the principal cannot completely observe and verify these skills or abilities when the agent is hired. (Jensen & Meckling, 1976)

## Two Approaches to Deal With Agency Problems

The literature suggests two approaches for investor – firm relations to decrease agency problems within a firm. The first approach is called the *Principal-agent approach* and is considered to be the classical agency theory, which is concerned with determining the optimal contract between the two parties (Jensen & Meckling, 1976). Formulating an optimal contract requires detailed pre-investment screening and due diligence of the firms in order to reduce information asymmetries and hence better contracts can be negotiated. In contrast, the second approach called the *Incomplete contracts approach*, argue that contracts are always incomplete, and therefore the ex post allocation of control is of higher importance compared to the ex ante screening and contract writing. Both these theoretical approaches advocate risk reduction at each stage of the investment process, although the two approaches emphasise different stages of the process (Van Osnabrugge, 2000).

### The Principal-agent Approach

One way for principals to deal with potential effects of moral hazard and adverse selection in order to reduce information asymmetries is to limit divergences from his/her own interests by incurring screening costs.

The implication of this is that the more comprehensive the contract can be formulated, the better the principal is able to influence the agent's behaviour. The theory identifies two types of contracts to use, either *behaviour-* or *outcome-based contracts*. Behaviour contracts are rarely developed in the negotiation process, but more likely to be developed in the on-going collaboration between the two parties. In these types of contracts, the agent often stipulates the agent to limit any devious behaviour and the principal will incur monitoring costs (behaviour-based observation) to ensure the agent behaves in accordance with the agreement. Behaviour contracts are most feasible if the principal can observe and verify the agent's behaviour. On the other hand outcome based contracts are better in situations when the principal is not able to observe the agent which is often the case in the relation between private investors and entrepreneurs. (Van Osnabrugge, 2000).

The principal will then establish appropriate contractual incentives for the agent, reliant upon the agent's performance, called outcome-based contracting (Jensen & Meckling, 1976). In the negotiation process it is more common to negotiate outcome-based contracts. Both methods for controlling the agent to act accordingly to the principals' agenda involve costs for information gathering and contract formulation. This trade-off between the costs of measuring behaviour and the costs of measuring outcomes and transferring risk to the agent is the heart of principal agent theory (Van Osnabrugge, 2000).

### The Incomplete Contracts Approach

According to the incomplete contracts approach the underlying assumptions are that writing a good contract is too costly, since it will always be incomplete. This approach instead argues that it is the *ex-post allocation of control* that is critical for the relationship between the two parties. The Principal-agent approach on the other hand argues that all contracting costs for observing variables can be agreed upon less costly. However, in the reality contracting costs can often be sizable.

The three main explanations for why writing contracts are costly and making them incomplete are: the presence of transaction costs, bounded rationality, and asymmetric information. (Hart, 1995a).

The transaction cost approach argued that the costs of contracting on an unlikely event might outweigh the benefits, on account of four ex-ante costs, which are particularly important according to Spier (1992) who argues:

“First, the costs of thinking about all different eventualities that may arise during the contractual relationship. Second, the cost of negotiating with others about these plans. Third, it may be very difficult and costly to write a contract which, when it is violated and in dispute, is clearly verifiable by a third party—such as a judge (Hart 1995b). Fourth, there are ex post legal costs incurred, in addition to the ex ante writing costs, in actually having this contract verified and enforced by a third party”

Contracts in reality often tend to be simpler and less sensitive to environmental differences than framed in theory. Another explanation for incomplete contracts lies in the assumptions about bounded rationality, arguing that agents either have only limited ability to evaluate and elaborate contingencies (Van Osnabrugge, 2000). Asymmetric information can also be an explanation to incomplete contracts, arguing that a person may refrain from including a certain clause in the contract to signal his/her type as in the example of an entrepreneur with particular states (Spier, 1992).

A consequence of these three explanations can lead to renegotiating when new information arises. Not to forget is that these explanations put emphasis on contract formulation and less on the idea that power is important and the implementation of organizational arrangements to allocate that power (Van Osnabrugge, 2000).

### *Ex-post Allocation of Control*

If writing a contract would involve less costs, a fully comprehensive contract of all future scenarios could more easily be accomplished, this would decrease the effect of how the power is distributed between the two parties, since the contract would not have to be renegotiated. Power is in these situations referred to as the position of each party if the other party does not act accordingly to what has been agreed upon and behave opportunistically. Moreover, Hart (1995a) suggest that due to the fact

that contracts are incomplete, and cannot specify each party's obligation in every contingency, it is the ex-post allocation of power and control that is crucial.

A significant difference can be identified between large established firms with multiple shareholders and small entrepreneurial firms is that it is easy to build analysis upon real assets and the owners can execute ex-post control. In small start-up entrepreneurial firms, which is the focus in this study, it is hard to execute control through ownership of assets since the firms are highly leveraged and often do not have real assets. Hart (1995a) suggest that the best way for an investor to gain ex-post control in these types of companies is through being active and involved in the investment.

#### Comparison Principal-agent Approach and Incomplete Contracts Approach

Both approaches aim to limit agency costs at each stage of the investment, but in different phases where the Principal-agent approach focus more on the ex-ante and the Incomplete contracts approach is more focused on the ex-post. In the strive of formulating the optimal contract, the Principal-agent approach puts more emphasis on setting behaviour- or outcome based goals. Formulating an optimal contract that aims to reduce information asymmetries between the two parties involves pre-contract screening and due diligence to predict future contingencies (Jensen & Meckling, 1976).

The Incomplete contracts approach on the other hand, based on the findings of Hart (1995a) argues that due to the fact that contracts always are incomplete, it is the ex-post allocation of control that matters when investing in a firm. This can be accomplished through active involvement in the investment.

### 3.3 Trust

The Agent-principal theory described in the section above (Agent-principal theory) has been shown to be appropriate and relevant to use when analysing the relation between an entrepreneur and investor, since the relationship is sharply defined; with the investor providing finance capital and the entrepreneur providing market knowledge and business commitment. Furthermore the relationship is clearly

distinguishable, with the skill sets of each being almost disjointed. It also offers considerable opportunities for mutually beneficial contracting (Reid, 1999).

However, due to the dynamic ownership arrangements that surround the entrepreneur and investor relationship the Agent-principal theory's explanatory ability is limited and hence needs to be complemented (Arthurs & Busenitz, 2003). The impact of trust on the relationship between investors and entrepreneurs serves as an alternative explanatory factor when analysing the relation. Trust between investors and entrepreneurs is essential in order to overcome control problems, especially in a surrounding with severe agency risks and incomplete contracts (Manigart et al., 2002).

### 3.3.1 What Is Trust?

A commonly used definition of trust is "the subjective probability with which an agent assesses that another agent or group of agents will perform a particular action". There are two types of trust that are relevant in this context, personalized and generalized trust. Personalized trust is the perceptions that a person has about the behaviour of another specific person. Generalized trust is in contrast a set of beliefs about the behaviour of a random member of an identifiable group of individual. The main difference between these from an econometric perspective is that generalized trust is exogenous to the specific micro-environment transaction, meanwhile personalized trust is endogenous. The implication of a distinction between these in an entrepreneur and investor relationship is especially relevant since an investor and entrepreneur typically do not know each other beforehand the negotiation process and after the process and contract they will work close together. At the beginning of the relationship, meaning during the negotiation process, the generalized trust between both parties is exogenous. The national identity of the investor's individual partners further contributes to the effect of trust. (Bottazzi et al., 2011)

### 3.3.2 Implications of Trust

It has been found in the literature that trust has a significant effect on the investment decisions of venture capital firms and furthermore that the effect of trust extends beyond the investment decisions and extends to how financial contracts are structured, which concerns the negotiation process. Often economists distrust explanations that depends on subjective beliefs. Trust is a subjective belief, but so is

furthermore economists' distrust of trust-based explanations. Hence, also the importance of empirically demonstrating the effect of trust. (Bottazzi et al., 2011)

Authors S. Manigart et al. (2002) makes a distinction between investors as venture capitalist and private equity investors. Since venture capitalist invests in an earlier stage of the company life cycle, the venture capital industry is characterized by large information asymmetries and uncertainty on the one hand, but on the other associated with extraordinary opportunities. For the private equity industry however, the main issue is the substantial agency problem they are facing when investing in a private venture. To be able to mitigate potential agency problems between investors and entrepreneurs both parties will screen each other beforehand and write contracts with the certain rights for both parties. Investors will then after the investment monitor the venture. The pre-investment screening and the negotiation process stands for a critical conversion from due diligence to post-investment interaction and the process by which this transition is ensured may be critical to the quality of the interactions that follow. In this case, trust helps to facilitate the collaboration, reduces agency and transaction costs and furthermore improves the company's ability to adjust to complexity and ambiguity. (Manigart et al., 2002).

There is an on-going debate in the literature regarding the relationship between trust and control. On one hand it is argued that control and trust are substitutes. For example in an interfirm cooperation where formal legal contractual agreements (control) and psychological contracts (trust) may be perceived as substitutes. On the other hand, some argue that "*a higher trust level does not automatically dictate a lowering of the control level, and vice versa*". This means that both trust and control has different roles in a partner relationship (Manigart et al., 2002).

From an experimental setting it has been found that trust has an impact on the desired contracts of entrepreneurs, but not on that of investors. The number of contractual clauses investors wanted to include in the ideally outlined contract was unchanged no matter of their level of trust or distrust of the entrepreneur. The findings suggested that trust may not serve as a substitute for legal contracts and monitoring, but rather that trust and control play complementary roles. (Manigart et al., 2002)

In contrast, the contract preferences of the entrepreneurs were affected significantly by the trust. Entrepreneurs that perceived a high trust condition tended to prefer a more elaborate contract. Furthermore it was shown that entrepreneurs were willing to give up control over investors when there was a high level of trust, which supports the perception of trust and control as substitutes. Additionally, a higher trust level induced entrepreneurs to accept higher level of control of the investor. (Manigart et al., 2002)

Empirical evidences have shown that trust among nations has a significant impact on the likelihood that a venture capital firm will invest in a business. When investigating trust levels in individual relationships between venture capital firms and entrepreneurs in order to see whether trust is associated with higher contemporaneous and especially higher future success and if monitoring and control mechanisms are used as an substitute for trust, it was shown that there was a significant reciprocal positive relationship between trust and success in the relationship between venture capitalists and entrepreneurs. (Duffner et al., 2009)

However, there is no empirical evidence for whether venture capitalist are able to predict success; which is then reflected in the trust level or whether a higher trust level from the venture capitalist's side has a positive effect and increases the entrepreneurs' motivation and effort level. Nevertheless, the findings of a positive relationship between trust and success implies that a higher predicted success probability may increase the level of trust and furthermore a higher level of trust may increase the entrepreneurs' motivation and effort level and thus lead to a better performance. It was also found that other significant determinants for success were the perceived quality of the entrepreneur, creditability on information, perceived importance of reputation and the stage of the entrepreneur's venture. (Duffner et al., 2009)

The monitoring level was identified to serve as a substituting mechanism to trust, in order to be able to handle agency issues. The quality of management and the credibility of information are in turn regarded as proxy variables for confidence or confidence-building mechanisms. (Duffner et al., 2009)

### 3.3.3 Trust as a Complement or Substitute

Trust has been shown to play either a complementary or substitute role in the relationship between an investor and entrepreneur as stated in above section. However, authors Botazzi et al. (2011) states that trust and contractual sophistication are complements, not substitutes. The implication of this is to incorporate the effect of trust into how financial contracts are structured.

Butler et al. (2009), contrast this and mean that there is a remarkable positive and monotone relationship at the aggregate level between trust and income. They have found a strong evidence of a hump-shaped relation between performance and trust in individual level data and the monotonically increasing relation in aggregate data. This implies that it has to be a right amount of trust as well.

## 3.4 Power

This section will describe how power can influence the negotiation process and the future relationship. Perspectives from theories about power can be seen as a complement to agency- and trust theories.

### 3.4.1 What Is Power?

Power is in a great extent acknowledged to affect negotiator performance. However, few efforts have been made to integrate the most salient theories of power into interconnected framework that can account for the results from a broad spectrum of negotiation relevant research (Kim et al., 2005).

A negotiators power can be critical for the quality of his or her success, since it has the possibility to determine the allocation of rewards in a contract. The implication of this is that the greater one's power relative to the power of others, the more resources will one be able to claim. The result is consequently a negotiation literature, which presents recommendations on how to improve one's power position. Most concepts of power are based on Weber's (1947) classic definition of power as the probability that a person can perform his or her own will despite resistance. The area of studies within power has been progressing and Kim et al. (2005) suggests a more dynamic model of negotiator power.

The model argues that power can be divided into four distinct components:

- *Potential power*: the underlying capacity of negotiators to receive benefits from their agreement.
- *Perceived power*: the negotiators' assessments of a party's potential power in the relationship.
- *Power tactics*: concern the negotiators' efforts to use or change the power relationship.
- *Realized power*: the extent to which the negotiators claim benefits from their interaction.

To be able to manage power effectively one need to assess the implications of these components. This definition will help to emphasize the dynamic nature of power relations and aims to overcome the numerous of limitations that have persisted in the power literature.

### 3.4.2 Implications of Power

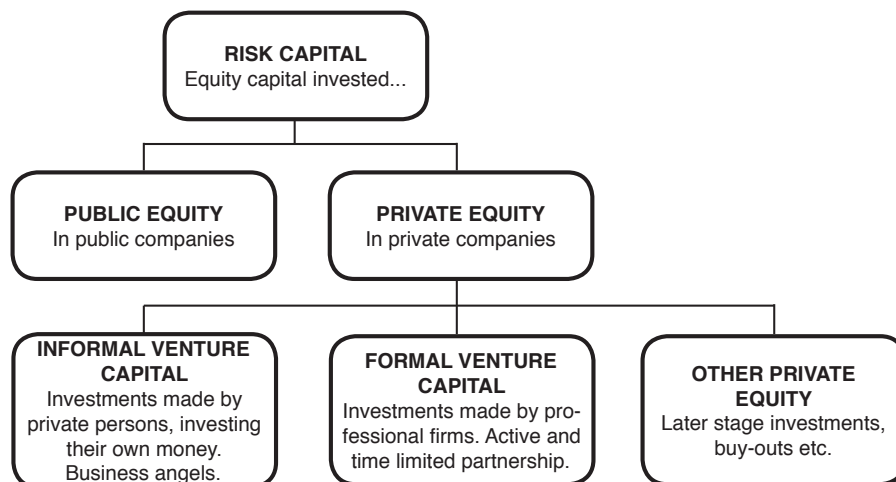
There is a complexity within power relations; their dynamic transformations and how power-related behaviours may be influenced by both short- and long-term considerations (Kim et al., 2005). The implication of these considerations within this study is to see to what extent and how power can influence the deal outcomes of the negotiation process and the future partnership.

## 4. EMPIRICAL FINDINGS

In this chapter a compilation of the findings from the interviews held with the entrepreneurs and investors will be presented. First the participants will be presented followed by a compilation of identified factors that influence the negotiation process in different ways.

### 4.1 Presentation of Actors

In this section, abbreviations for each respondent are established and will from hereon be used throughout the study. All the investors are active within private equity and furthermore within formal venture capital and private equity. The distinction between venture capital and private equity and other types of risk capital are presented below in figure 5.



**Figure 5.** Visualisation of different types of risk capital (Isaksson, 2010).

### 4.1.1 Investors

#### *Investor 1 - Private Equity*

Investor 1 holds a senior partner position in the buyout department on a leading Nordic private equity firm. Buyout strategy differs from venture capital strategy, since they normally invest in more matured companies when the risk premium is lower. Firm 1's buyout department invests in unlisted Nordic mid-market (annual turnover > 500 MSEK) companies in various industries.

The main targets set for their companies are growth, improved profitability and strengthened strategic position.

#### *Investor 2 – Formal Venture Capital*

Investor 2 works on an independent and partner owned venture capital firm investing in strong entrepreneurs leading innovative and fast-growing technology companies from Northern Europe. The firm typically invest in three different capital ranges; between €0.1 - 1 million in seed stages, €1 - 4 million in early stage and €5 - 10 million in the most matured stage. Investor 2 is general partner and co-founder of the firm and has been working with start-up investments for the past 10 years.

#### *Investor 3 – Formal Venture Capital*

Venture Capital firm number 3 is a small privately owned investment firm founded in 2009. Their business model is more similar to business angels and focuses on early stage investments in start-up companies, primary in the retail and service segment. Investor 3 is the CEO of the firm.

#### *Investor 4 – Formal Venture Capital*

Venture Capital firm 4 is a department within one of the largest banks in Sweden. The department focus primarily on investments in Nordic companies, in particular entrepreneurs in Sweden and Norway. As a respond to the fact that more and more companies within the venture capital industry invest in later stages, often in companies with an annual turnover above 50-60 MSEK, the department recently decided to quit their buyout strategy and niche on seed investments. Investor 4 holds the Global Head position of the department.

### *Investor 5 - Private Equity*

Investor firm number 5 is a partner owned Private Equity firm, founded 30 years ago. The firm focus on investments in high growth Swedish companies, often in entrepreneurial lead companies or family business with an annual turnover above 100 MSEK. Over the past thirty years firm 5 has been an active investor in almost 110 companies and among these 25 companies has been introduced to the stock exchange market. Investor 5 was is partner and investment responsible and has been working with these types of investments negotiations for more than ten years.

## 4.1.2 Entrepreneurs

### *Entrepreneur 1*

Entrepreneur 1 is an experienced entrepreneur and negotiator who has started several businesses within different industries and participated in negotiations all over the world. He has long experience of negotiations with Venture Capital- and Private Equity firms, as well as private Business Angels.

### *Entrepreneur 2*

Entrepreneur 2 is a young entrepreneur who recently started his second technological start-up business and joined a partnership with a venture capital firm.

### *Entrepreneur 3*

Entrepreneur 3 started his business three years ago together with a co-founder. Even though they were not in need of external financing they decided to join a partnership with a venture capital firm.

### *Entrepreneur 4*

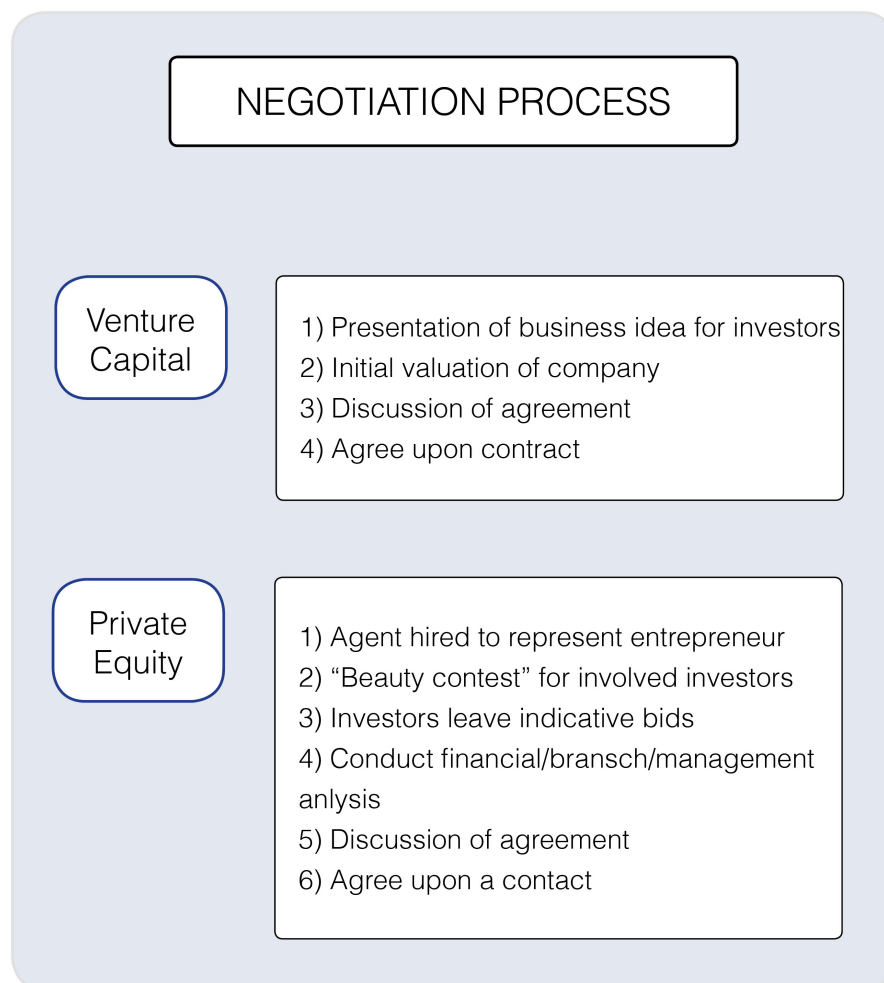
Entrepreneur 4 is an experienced entrepreneur and founder of a retail start-up business. He and his co-founder firstly financed their business through capital from friends and family, before they decided to join a partnership with investors within their operational business segment.

### *Entrepreneur 5*

Entrepreneur 5 and his co-founders started a partnership with a venture capital firm after their business had been established in almost 2 years to spin off the business and expand into new markets.

## 4.2 Definition of the Negotiation Process

The negotiation process differs between the venture capital and private equity firms and are visualised in figure 6 below.



**Figure 6.** A visualisation of the negotiation process within venture capital and private equity firms.

#### 4.2.1 Negotiation Process in Venture Capital Firms

Depending on the level of maturity of the company, the negotiation can be more or less focused on data in terms of previous track records and financial numbers. Due to this lack of available data, the evaluation of start-up companies is often more focused on the entrepreneurs' capabilities than on financial analysis. According to both the entrepreneurs and investors, personal chemistry between the parties is one of the most important factors for reaching an agreement and to begin a future partnership. Investor 3 described:

*"I am searching for driven entrepreneurs that I feel I can trust and have the right connection to. Our firm is looking for business ideas that are easy to understand and will give positive cash flows in a near future"*

The first meeting is normally open-ended without any further expectations and aims for the parties to get to know one another. In general, the entrepreneur convinces the investor about the business idea, while the investor promotes how they will add value and enable new opportunities for the company. Thereafter the negotiation begins, or the 'on-going discussion' between the parties as the majority of the respondents prefers to call it. Normally this discussion takes approximately about three months before an agreement is reached. All respondents agreed upon that the negotiation process is essential for how the future collaboration will turn out; a recurring comparison were that the negotiation process is like the "dating phase" in the beginning of a relationship. Investor 5, stressed the need to take the most critical questions as early as possible to determine whether they will come to an agreement or not. Building long-term relationships is an important part, and many times entrepreneurs and investors met long time before the actual deal take place. Investor 3 confirmed this:

*"The right persons are always important to have in our network".*

The investors also stressed how the perception of the entrepreneurs' credibility is strengthened if they are active in discussions and not only accept all suggested alternatives.

#### 4.2.2 Negotiation Process In Private Equity Companies

The negotiation process in more mature companies (investing in a later stage of the companies life cycle) differs significantly from start-up negotiations and is called auction processes. Normally, the selling company, often entrepreneurial, hires an agent to represent his/her interests. The agent thereafter invites potential investors, often private equity firms or institutional funds to participate in the negotiation. The first step is to define a preliminary valuation in a so-called "beauty contest" of the company. This step aims to identify the seriously interested investors. One reason for why the process is divided into these steps is to avoid revealing too much information to external parties that may not be willing to actually bid on the company. Thereafter, the interested investors will leave more indicative bids containing more detailed information. Normally two or three investors will continue to the next step of the actual negotiation process. During that time, the investors often conduct deeper financial-, industry- and management analysis in order to be able to make a more accurate valuation until they leave a bid.

#### 4.2.3 Crucial Points to Agree Upon

The respondents described some important questions, often discussed in an early stage that could be defined as crucial for the forthcoming negotiation.

First, come to an agreement regarding the business idea and how much capital that is required. Often the first invested capital can be used to set milestones of desired goals that should be accomplished before more capital can be invested. The initial amount of capital that the investment firms invest differ, but this study has a focus on initial investment normally ranging from 0,5-100 MSEK.

Secondly, both parties need to agree on what risk level the company should operate on. Some entrepreneurs viewed external funding as security against incidents, while venture capital aims to give the company opportunities to explore new, more risky and profitable ways.

Thirdly is to align future expectations. The invested capital must be realistic to the investors required returns. Investor 4 explained:

*“If X invest 50 MSEK for 50 % of the ownership, the company is valued to 100 MSEK. To receive an annual return of 20 % the company has to increase in value to 420 MSEK in 5 years, which very few companies in Sweden are sold for today”.*

This can often cause different opinions between the parties regarding the valuation of the company's actual value. Investor 4 emphasize the importance of in an initial stage be clear about how much the entrepreneur can expect and keep their promises not to risk bad will.

#### 4.2.4 Valuation Methods

Different methods can be applied to estimate the approximate value of a company. For matured companies multiples analysis is applied in an early stage to approximately estimate how much the company is worth. How accurate these analysis are depends on how many similar companies that exist and how many transactions that have been made on the market. From the initial estimation there can often range +/- 25% between different investors depending on how much growth they predict within the industry and how they estimate the company's capacity.

In start-up companies, when not as much data can be provided, investors often use other variables to estimate the valuation. Firstly, the valuation starts with traditional analysis of financial numbers, mostly focusing on making realistic estimations of future sales and profits. The future predictions often differ between the investor and the entrepreneur due to the fact that the investor will have to include how much the company is worth at exit time.

#### 4.3 Strategy For the Negotiation Process

This section will describe the evaluation criteria briefly, the influential factors in the partnership and how the negotiation process influence the forthcoming collaboration.

### 4.3.1 Evaluation Criteria

In this study, the negation process is defined to begin after investment criteria have been evaluated. Hence, there will be no further discussion regarding the underlining evaluation of these criteria, more than mention the most important ones the investors consider when deciding upon investing in a business idea. The majority of the investors have agreed upon several factors that have to be above an acceptable level for the investment to even be considered. These factors can be inter-mutually weighted differently depending on company and situation. The business idea has to be:

- *Unique*: preferable through patent or similar,
- *Scalable*: to different concepts and market sizes
- *Globally distributed*: attractive for distribution on global markets.
- *Experience growth within the segment*: in a segment predicted to experience rapid growth in a near future.

What all respondents also emphasized repeatedly was the importance of right people. Investor 2 said:

*“The best entrepreneurs are looking for a partner to work with and not only the highest valuation of their company.”*

Investor 2 further believed this to be the most important factor for an entrepreneur in his/her choice of investor. This was confirmed by the entrepreneurs, and especially emphasized by the most experienced entrepreneurs. Apart from the personal chemistry the majority of the entrepreneurs agreed upon the following evaluation criteria to be the most important in choice of investor:

- Core competence within the industry
- The investors/investment firms reputation and references
- Portfolio companies, whereas entrepreneurs often value investors with portfolio companies in the same industry
- The size of the investors' fund; how much capital the investor will be able to provide over time

As entrepreneur 5 explained:

*“We were looking for an investor that did not only contribute with capital but also engagement and a broader network.”*

The study indicates that entrepreneurs tend to value the investors network within the industry and area specific competence more the second time they considered external capital. They further explained that another factor crucial for a healthy relationship is high transparency and not too high short-term pressure on deliverables, since that may result in a less innovative working climate for the entrepreneur. The majority of entrepreneurs recommend other entrepreneurs contracting a number of investors when searching for capital. Aiming to broaden the different options and increase the entrepreneurs' negotiation power.

#### 4.3.2 Influential Factors In the Partnership

There are various opinions among the entrepreneurs about how they feel regarding owning the majority of the company or not. Entrepreneur 1 for example, did not have a problem losing his majority position to his investors. He explained how the minority protections in the agreement made him feel comfortable of remaining influence. On the other hand, it was very important for Entrepreneur 3 and 5 not to lose their majority ownership to an external investor. They explained how they would feel afraid of losing the company's personal characteristics and own motivational incentives if it would no longer be their company. Entrepreneur 5 described a trade-off between how many shares to sell and enough capital to increase the company valuation significantly over a couple of years. To increase his own negotiation power and get a better understanding for his company's actual value, he ended up taking in several term sheets from different investors to evaluate against each other.

Furthermore, how the agreement is formulated is important for how the entrepreneurs perceived their *power* in the company. For example incorporated Entrepreneur 3 in the shareholders agreement that he and his partner shall remain majority owners. His investors on the other hand have veto decision rights in certain decisions. Within this contract he perceived himself to have great ability to execute influence in the company.

### 4.3.3 How the Negotiation Process Influence the Forthcoming Collaboration

Fundamental based critical factors for the future collaboration between the parties is the reason why entrepreneurs seek external funding and how they feel about it. Investor 4 explained how these feelings affect their relationship when describing how some entrepreneurs want to avoid external investors, but is forced to take in funding for the company's survival, while other entrepreneurs view the external funding as a great opportunity to accelerate the business to the next level. Moreover, an important factor for how the collaboration turned out was whether the entrepreneur had previous experiences of working with investors or not. Entrepreneurs with previous experience were often more confident in the structuring of funding as well as how they viewed the partnership. Entrepreneur 5 explained:

*“One of our co-founders has previous experience of start-ups and venture capital funding, which was proved to be extremely valuable for us when joining our partnership”*

### Differences In Influence Between Private Investors

A difference can be identified between different types of private investors.

Venture Capital investors often acquire 20-50% of the companies, while Private Equity companies strive to be majority owners acquiring more than 51%. This can partly be explained by the fact that they often have more pressure to exit whenever it is required. Investor 1 said:

*“We only invest in companies where we can own the majority, this is because we always want to be able to exit whenever we have to and we ourselves have to attract institutional funds to invest (often a requirement from them to only invest in majority hold companies).”*

This type of investors is often preferable for mature companies that might lack in-house management competence or problematic owner relations. Another reason to take in external funding from well-known investment firms can be to increase legitimacy for the company.

If the entrepreneur is a key person for the company's business, and the investor want to acquire a significant share of the company, one way to create incentives for the entrepreneur to run the business the best possible way can be to negotiate about a high enough reinvestment, normally more than 25% from the entrepreneur.

#### 4.4 Formulating An Agreement

The agreements are a central part in the negotiation process since these reflects a tangible outcome of the process.

All respondents used three types of contracts when signing an agreement, but there were different regarding the content. These are: *Share Purchase Agreement*, *Guarantee Agreement* and *Shareholders Agreement*.

*Share Purchase Agreement* (SPA) is the first contract, which includes their requirements on amongst others directed new shares issues and preference shares in case of liquidation or an exit. Investor 4 meant that preference shares could be used as an incitement to motivate a higher valuation, because if the business idea fails the investors' capital will be repaid first. SPA is relatively problematic to understand within the Swedish Law, since it has many American concepts.

The second contract is the *Guarantee Agreement*, which is a guarantee if there are any irregularities. As mentioned above, often the guarantee responsibilities differ between the investor and the entrepreneur, where the entrepreneur often has a greater responsibility since they have more insight in the operational business.

*Shareholders Agreement* is the third type of contract, which states the relations of power and affecting the relationship. This is normally a matter of fact of what is reasonable or not. According to Investor 3 they have certain critical points in the Shareholders Agreement that they as investors would not stretch. If the investor and the entrepreneur do not agree on these it will normally not be a deal. Entrepreneur 2 who took in capital in a very early stage valued the possibility to get started higher than what percentage share of the company that was necessary to give up. He also explained that some of the points in the Shareholders Agreement they could not

agree upon initially, but after a while he as an entrepreneur gave in and adapted to the requirements of the investor.

Entrepreneur 4 explained that they have good general agreements with their national investors, but assumed there will be more restricted agreements if they decide to bring in an international investor. He explain that one way his firm used to create incitements in contracts with their own agencies was to allocate all risk to the agencies and also included a possibility to end the contract if the agencies makes a subjective reach.

Investor 5 confirmed this and explained that one way to manage future uncertainties that are impossible to contract about is to share risk between both parties. Besides, by not creating to restrictive contracts and instead share the risk this will keep up the motivation for the entrepreneur. Entrepreneur 1 explained that how the contracts are formed depends on the culture of the country. In the Nordic countries and central Europe there is a higher degree of trust and they have generally more confidence in each other within business. In the Anglosaxian countries there is higher degree of focus on paragraphs and the contracts aims to cover all possible outcomes, which the entrepreneurs means is impossible and often *"kills the business"*.

Entrepreneur 3 formulated a shareholder agreement that was specific for the two forthcoming years and thereafter a renegotiation. To make his investor satisfied with the agreement and secure their interest in the company to remain he formulated an agreement giving them rights for one board member and veto decisions regarding;

- Corporate governance
- Business plan for the company
- Budgets and investments above a certain level
- Dividends and acquisitions

This structure of the contact gave both parties positions to influence. When it comes to the question regarding how his investors controls him Entrepreneur 3 answered:

*"Not to forget is that our investor is depending on our performance, and that we are motivated to do our best, since the investor often is the more passive owner. This results in the fact that the investor will not run over our opinions since they have incentives to keep us happy."*

Apart from the veto decisions they contracted about, he further explained how they incorporated certain paragraphs regarding the most likely conflicts that may arise in the future. He stressed that these paragraphs will also protect him if his investors do not fulfil their obligations. Investor 3 agreed upon the need of incorporating more structure into the negotiation process as Investor 1 also stressed.

He, together with Investor 2, promoted the usage of serious seed to a greater extent, since this has proved to make both parties more comfortable in the negotiation. Serious Seed is a form framework for investments and are relatively new standards that aim to facilitate the investment process by served as guidelines.

## 4.5 Problems Arising In the Negotiation Process

The interview sessions distinguished some frequent problems that arise in the negotiation process. Firstly, the investors explained that it can be problematic to describe their income model for the entrepreneur, and that the investor will have to build the company valuation upon realistic and not optimistic analysis in the valuation. Therefore, the investors stressed how important it is to discuss this in an initial phase. What moreover can be more problematic is guarantees and Investor 5 explained:

*“In general the investor will not have to leave the same guarantees as the entrepreneur in a future exit, due to the fact that they have not been active in the operational business and can therefore not take the same responsibilities”.*

A problem that has been raised during the interviews is that it can be problematic for the entrepreneurs to decide the amount of capital to ask for. Often investors, depending on their own investment philosophy has different structures to follow in how much, and when they can invest. If the entrepreneur do not fit into any of this frames, due to asking for too little or too much capital, they might face problems finding financing even though they have a great business idea. Moreover, problems regarding how the company should be managed can often be reduced through clearly defined business plans, which often also help to calibrate future expectations from both parties. If there are large oppositions already in the negotiation process, it usually ends with both parties leaving the table without reaching an agreement.

Entrepreneur 3 described that when there have been conflicting interest between him and his investors the discussion have ended heading his direction. He believed that his investors “*pick their fights*” and if it is not a discussion regarding a major decision they believe it is better to let he do what he thinks is best and will keep him motivated.

Other problems that could either lead to the fact that the negotiation process ends or solely making the negotiation process more complicated can be distinguished. Investor 3 explained that a critical factor is that both parties do not agree upon the capital requirement, as mentioned earlier, there can often be separate opinions about the company’s valuation and capital need.

Another issue to handle is the separation anxiety that may arise during the process from the owner. When the owner truly realizes that his or her company is going to be sold and all the advantages that comes with ownership is going to end, they sometimes get cold feet and end the process.

Investor 1 explained:

*“The entrepreneurs realize that it is not only about money, it can be about giving up a certain position in a small society”.*

Investor 3 stressed the fact of critical points in the Shareholders Agreement. This is crucial from both parties since they both most often have their standpoints they want to incorporate in the Shareholders Agreement. He also mentioned during the interview that “*gut feeling*” is a critical factor in the negotiation process. If they have a good feeling about the entrepreneur and the business idea the process can proceed much faster. Furthermore is a critical factor according to him the budget. Unrealistic expectations on what to achieve and be done are in many cases interlinked with the budget proposal and this can be a point of disagreement, which leads to an end of the process.

## 5. ANALYSIS

Most critical factors and problems within the negotiation process could be analysed and explained due to information asymmetries from the implications of how to allocate control within contracts. However, there were situations that could not be fully explained within the framework of agency theory and where explanations instead could be found within the frameworks of trust and power.

### 5.1 Analysis of Information Asymmetries

The principal-agent issues regarding information asymmetries and how to allocate control within contracts were shown to give rise to critical problems in the negotiation process. Firstly, a distinction between different agency problems needs to be defined, since the investor-entrepreneur relation is characterized by higher degree of alignment of goals than for example in an owner-employee situation. As Entrepreneur 3 explained how he and his investor's goals were aligned:

*“Both me and my investors main goal is that the company is profitable, then of course we sometimes have different opinions about how to accomplish that”.*

In other situations, for example between an owner and an employee there can often be a greater discrepancy in the employees' individual goals than between two owners, as in the studied relation.

#### 5.1.1 Adverse Selection

Information asymmetries primary exist in the initial phase of the negotiation process when the investors try to estimate the value of the company and the entrepreneurs' actual capabilities. This can for example result in that the entrepreneur tries to overestimate the company's actual potential to receive a higher valuation, or falsely claim that the company has resources that it does not (Jensen & Meckling, 1976). This problem is as earlier mentioned called *adverse selection*. According to the empirical findings, if this false information or unwanted traits come to the surface, it often results in a cancelled deal. The study has shown that this kind of problem result in more crucial consequences if the investor acquires 100 percentage of the company rather than a minority post and the entrepreneur reinvest as well. However,

the empirical findings contradict that this is a major issue in reality, partly because it is the venture capital industry that has been investigated, where minority investing is most common, but also in private equity investments. One explanation is that it is the investors' own task to find reliable data to make an accurate valuation upon. Also this informational advantage can be reflected the other way around; the investor can have an informational advantage if they hold information that the entrepreneur is unaware of. For example if the investors have information regarding a certain regulation that will be extremely beneficial for the entrepreneur's business and suggest an acquisition before this information is public. However, information asymmetries can, but in reality rarely do, therefore play a significant role for the deal outcomes of the negotiation process.

**Conclusion 1**

Adverse selection problems exist in the negotiation process in terms of holding information or due to lack of important knowledge. This primary arises if that one of the parties falsely claims data or resources, and can be a critical part for the deal outcomes.

### 5.1.2 Moral Hazard

The most common moral hazard problem the study has defined to exist in the negotiation process is when to decide an appropriate risk level for the company. This is also in accordance with the theories of Jensen and Meckling (1976). Investor 4 explained how one of the most critical factors to reach an agreement is to agree on an aligned risk level for the company. If there are too conflicting opinions regarding this question, the deal is often cancelled. As earlier described, this relation differs in contrast to an owner-employee relation, whereas the entrepreneur often will have to face the same consequences as the investor, resulting in that the entrepreneur has less monetary incentives running the company at a higher risk level than agreed. Nevertheless, the findings support to explain that this issue often arises due to personal characteristics whereas some entrepreneurs tend to be more risky while others are more risk averse.

### How the Parties Mitigate Agency Problems

Empirical findings support that private investors on the Swedish market tend to prefer the contracts incompleteness approach over the classic agent-principal approach as described in theory by Hart (1995a) and Jensen & Meckling (1976). Entrepreneur 3 explained that it is impossible to contract about all potential forthcoming problems, a fact which is also confirmed by Investor 3 and 5. The study showed that the investors primary execute their control through active involvement in the investment, but also through trust which will be further analysed in section 5.2 Analysis of Trust.

Within the Principal-agent approach the study indicates that investors prefer to use both outcome-based and behaviour-based control depending on situation and company. Investor 3 explained:

*“In start-up companies it can be problematic to use outcome-based contracts, since there is a no data to forecast the goals upon”.*

In this situation behaviour-based contracts are preferred to use, often through communication on daily basis between the two parties. Another important factor is that small start-up firms are operating in an unstable environment and may only be partly affected by an agent's effort. The choice of which approach to apply also depends on how close the parties work. According to Jensen & Meckling (1976), agency costs can be sizable and reduced if the principal is able to observe the agent, when using the behaviour- instead of the outcome-based approach. The respondents explained how the observation could take different forms, both through daily communication but also through board representatives from the investment firm. Nevertheless, the study showed that none of the respondents worked as close as they were able to physically observe each other on daily basis. The implication of this is that the behaviour approach needs to be complemented with further explanation. Trust has been found to provide a complementary explanation to this and will be further explored in section 5.2 Analysis of Trust.

**Conclusion 2**

Moral Hazard problem often arises in terms of conflicting preferences regarding the company's risk level. The most common way to handle moral hazard problems is through the incomplete contract approach, whereas trust partly has a complementary explanation.

### 5.1.3 Agency Costs

Fama and Jensen (1983) suggest that contract can be implemented to defend rights, performance evaluation criteria and payoff functions for the agent.

Entrepreneur 3 and Investor 5 explained how this could be used most accurately; trust and confidence between the parties tend to increase when dealing with crucial issues in an early phase of the negotiation process, resulting in a better future relationship. According to them it is critical to contract about these potential issues as early as possible, to determine whether the parties will reach an agreement or not. The cost for structuring contracts (Van Osnabrugge, 2000), was according to our respondents rarely estimated in monetary terms, but rather in time of delaying the negotiation. A vast majority claimed that if it is too much discussion regarding each paragraphs in the contract, it often indicates that there will not be a good future partnership and then choose to cancel the deal. One way to avoid transaction costs for contracting is using more standardized contracts, for example serious seed to a greater extent. Investor 2 explained that using these types of contracts would not only decrease the costs for formulating contracts, but also give the entrepreneurs higher confident in the actual meaning of the contracts. If the contracts were well known and widely used, there would be more public interpretations of these contracts.

Moreover, according to our respondents when trust is high, there is less need for restrictive control incentives, which increases the motivation for the entrepreneurs to work hard for the business. Critical discussions often concerned the company's risk level or exit time for one of the parties, and in this type of situations more restrictive contracts was proved to be useful.

**Conclusion 3**

Empirical findings support Fama and Jensen's (1983) thesis, claiming that the benefits of contracting have to exceed the cost of formulating the contract. If the perceived sacrifices for contracting are too high, often in terms of conflicting opinions, it can be a critical factor for the negotiation resulting in a cancelled deal.

## 5.2 Analysis of Trust

The study has identified trust as one of the most critical factors in the negotiation process. Empirical findings tend to confirm, what Bottazzi et al. (2011) suggest, about trust's significant impact on investment decisions, both regarding the negotiation process and deal outcomes as well as beyond that point in a future partnership.

In accordance to Manigart et al. (2002), the empirical findings support the thesis about that the behaviour approach can be controlled through other substituting channels, such as for example *trust*. Consequently, both entrepreneurs as well as investors, argue that one of the most important investment criteria is to feel trust and that the other party provide high credibility. Trust also strongly relates to how legitimacy is perceived, whereas both factors affect the investor-entrepreneur relationship (Hart, 1995b). The implications of trust will be described more thoroughly in the next section.

### 5.2.1 Perceptions of Trust

The personal trust that both parties describe as one of the most critical factors in an initial phase of a negotiation can be defined as *personalized trust*, characterized by personal chemistry as defined by Bottazzi et al. (2011). *Generalized trust* on the other hand can be identified on a macro level, whereas several investors have addressed differences in how trust is perceived between Swedish investors versus international investors. Entrepreneur 1 explained how trust in these situations takes a more informal form in relations between two Swedish actors compared to when a Swedish entrepreneur is negotiating with international investors, where more attention is paid to the formalities in the contract. He further explained how this often

results in the fact that there are fewer requirements to strictly contract about all potential issues that may arise in a future. Both parties address how trust can play a significant role in determining the size of future agency costs, which can be reduced if they perceive a higher trust to each other.

### 5.2.2 Implications of Trust In the Investor – Entrepreneur Relationship

This study partly confirms that control and trust are substituting each other. In situations when the investor has difficulties controlling the entrepreneur and the parties trust each other, the need for controlled reporting is reduced, and they can be perceived as substitutes.

According to the findings, trust can also have a complementary role, different situations require different types of control and in more matured companies more restricted control can be executed. This is not due to the fact that the investor does not trust the entrepreneur, but rather because larger organizations can, and need to be controlled in a more structured manner.

Moreover, the type of ownership the investment firms itself has, has certain implications for how control versus trust are applied. If the investment firm, such as for example investment firm 5, invest institutional capital they often have higher requirements of formal reporting, while fully private owned companies, such as for example the firm of Investor 3, only uses informal control incentives. From the empirical findings it has not been possible to distinguish differences between how entrepreneurs and investors perceive the importance of trust as Bottazzi et al. (2011) suggests. Furthermore, differences can be distinguished on an individual level rather than on group level, whereas respondents who perceived a high trust condition tended to prefer more elaborative contracts. It was also confirmed that higher level of trust lead to more willingness to give up control, which supports the perception as trust and control as substitutes. Nevertheless, as the theory of Duffner et al. (2009) claims, when trust is high in the relationship between investors and entrepreneurs, it serves as a complementary tool for a less comprehensive contract. As Investor 3 explain how they initially established rather simple contracts if they perceived the trust as high in the relationship to the entrepreneur and do not want to waste time on

contracting on details. This can also be applied in the incomplete approach whereas trust can be substituting by reducing monitoring and controlling agency issues. Furthermore to address is that although some entrepreneurs were afraid of being too restrictedly controlled due to the fear of that control kills innovations, control was also shown to have motivational impact when being used as a tool to set clear goals for long-term agendas.

**Conclusion 4**

The empirical findings tend to support that trust is the most critical factor in the negotiation process. Trust can have both substituting effects, when control incentives are reduced thanks to higher perception of trust, and complementing effect, when trust complement a less comprehensive contracts.

### 5.3 Analysis of Power

The implication of power considerations within this study is to see to what extent and how power can influence the deal outcomes of the negotiation process and the future partnership. Initially we assumed the allocation of power would have a significant influence on the negotiation process and deal outcomes. The empirical findings showed that power factors did not have the impact we firstly assumed.

Due to the relatively short time period the study focus on, in accordance with the theories of Kim et al. (2005) it was found that perceived and realized power influence the deal outcomes the most. Initially the investor party can be perceived to possess most power, both in terms of perceived and realized. This since they de facto provide the capital, have more experience of negotiations and in general have more investment options than the entrepreneur has financing options. There do exist cases when it is the opposite, for example if the entrepreneur has a unique business idea that many investment firms are interested in. The interview sessions showed that although the investors had more power, it did not affect the process to a great extent. None of our respondents claimed that the power relation had a significant impact of the negotiation, nor the relation. Rather, the respondents argued that both parties in general tried to avoid power imbalances. They explained how power imbalances often could have a decreasing motivational effect on the entrepreneurs'

innovativeness and therefore the parties often instead strived to reach aligned goals for the firm.

Moreover, the interview sessions indicated other factors that had a greater impact of how the negotiation power was distributed. The more different options one party had, the less depending they were on the other party, resulting in higher negotiation power. Entrepreneur 5 explained how he increased his negotiation power when requesting term sheets from several different investors. Moreover, Entrepreneur 2 confirms this by explaining that if he would redo his negotiating he would contact more investors before signing an agreement. A more dynamic consideration of what effects power may have is the intentions behind joining a negotiation. Investor 4 stressed that a critical factor for a future successful partnership beyond the negotiation process, is the reason to why an entrepreneur choose external funding; if they felt forced to, or saw it as an opportunity. If the entrepreneur felt forced to take in external capital due to own financial constraints we could see tendencies whereas the investor can use his/her power advantage to obtain more resources to a lower valuation. Furthermore, how the agreement was formulated was shown to affect how the entrepreneur perceived their power to run the company. Entrepreneur 1 explained how he perceived his ability to still execute power in his company, also after an acquisition where he sold his majority holding, thanks to his minority protection and veto decision rights.

**Conclusion 5**

Theories describing how the allocation of power influence the negotiation process are not considered as major critical factors in the negotiation process according to the empirical findings. Hence, the empiric does not support an application of the theories by Kim et al (2005) as to be an important part of the negotiation.

## 5.4 Further Reflections

The analysis identified a critical factor crucial for the negotiation process, which could not be explained within the theoretical framework. The separation anxiety between the entrepreneur and his/her company was brought up by both Investor 1 and 4 and was perceived as a critical factor that could result in a cancelled deal. This critical factor is hard for any external party to influence and moreover difficult to explain

directly within the theoretical framework of this study. Nevertheless, it could in a more implicit manner be explained within the trust approach. The implication of this is for the investor to build up trust over a longer period of time, often even before the entrepreneur has considered selling his/her company. This would then prepare the entrepreneur for the sale and creates a greater timespan for reflection, which in the prolonging hopefully reduces the separation anxiety.

## 6. CONCLUSION

In this section conclusions are drawn to be able to answer the posed research questions in order to fulfil the purpose of identifying the critical factors in a negotiation process between entrepreneurs and private investors.

### 6.1 How Do Investors and Entrepreneurs Reason and Act in the Negotiation Process?

In sum, it is possible to distinguish that both parties reason and act quite similar in the negotiation process. One reason for this is because their goals in order to reach success needs to be coherent and intertwined in a greater extent than in a general agent – principal relation. All respondents agreed upon that the negotiation process is essential for how the future collaboration will turn out and a frequently used comparison was that the negotiation process could be interpreted as a dating phase as in the beginning of a relationship. The importance of the right people and to find a good partner to work with rather than a highest valuation was stressed among all the entrepreneurs.

A difference between the investors and entrepreneurs regarding how they reason and act in the negotiation process is the perception of the amount of capital that is required for the venture. Entrepreneurs might not understand the income model or the investment model of the investor and hence reason differently upon the valuation.

The negotiation process can be more thoroughly studied in section 4.2 Definition of the Negotiation Process.

### 6.2 What are the critical factors in the process and how are these handled?

The research question was addressed within the theoretical frameworks of information asymmetry, trust and power and the conclusions will be presented below.

### 6.2.1 Information asymmetries

Most of the critical factors could be explained due to information asymmetries from the implication of how to allocate control within contracts.

**Conclusion 1**

Adverse selection problems exist in the negotiation process in terms of holding information or due to lack of important knowledge. This primary arise if one of the parties falsely claims data or resources, and can be a critical part for the deal outcomes and lead to a cancelled negotiation process.

**Conclusion 2**

Moral Hazard problems often arise in terms of conflicting preferences regarding the company's risk level. The most common way to handle moral hazard problems is through the incomplete contract approach, whereas trust partly has a complementary explanation.

**Conclusion 3**

Empirical finding support Fama and Jensens (1983) thesis, claiming that the benefits of contracting have to exceed the costing for formulating the contract. If the perceived sacrifices for contracting are too high, often in terms of conflicting opinions, it can be a critical factor for the negotiation resulting in a cancelled deal.

### 6.2.2 Trust

The analysis showed that trust was one of the most critical factors in the negotiation process.

**Conclusion 4**

The empirical findings show that trust is the most critical factor initially in the negotiation process. Trust and control can have both substituting effects, when control incentives are reduced thanks to higher perception of trust, and complementing effect, when trust complement a less comprehensive contracts.

### 6.2.3 Power

The analysis contradicted the initial assumption of the impact of power within the negotiation process, where it was shown that power did not have a significantly high impact.

#### **Conclusion 5**

Theories describing how allocation of power influence the negotiation process are not considered as critical factors in the negotiation process according to the empirical findings. Hence, the empiric does not support an application of the theories by P. H. Kim et al (2005) as to be an important part of the negotiation.

## 6.3 What Areas of Improvement Exist in the Negotiation Process?

A vast majority of the respondents stressed the fact that both parties need to be satisfied with the outcome of the negotiation process and a concluding area of improvement for both parties is to in an early phase agree upon the main characteristics in the agreements and remember that the negotiation process is seen as a start on a long-term relationship and hence both parties need to be satisfied. Hereafter is a compilation of the most important practical factors aiming to improve the negotiation process from the different perspectives of an investor and an entrepreneur.

### 6.3.1 From the Perspective of an Investor

- Investors need to initially explain their expectations of the future, the business model, who they are and what they want to achieve. This can be seen as a form of education for new entrepreneurs.
- Introduce a formal due diligence and use formal agreements and contracts, such as for example Serious Seed in a greater extent.

This would reduce transaction cost by diminishing the need of establishing a new contract every time. To keep in mind is although that each investor and entrepreneur would probably like to formulate it differently each time, since no companies are identical.

### 6.3.2 From the Perspective of an Entrepreneur

- Entrepreneurs need to understand the investment model of the investor and how much capital investors invest in companies. As earlier mentioned, investors often have certain ranges of the sum of money they invest, whereas it can sometimes be easier to get more capital than less.
- Entrepreneurs should carefully question the shareholders agreement, since the investors most often formulate it. When entrepreneurs are supported with professional help from e.g. lawyers or experienced start-up incubators they often tend to feel more confident and satisfied with the negotiation.
- In order to receive funding easier it would be preferable that the entrepreneur professionalizes the firm in earlier stages than what is most common today. By acquiring greater knowledge about best practice of how investments are made it could furthermore facilitate this. This knowledge could be collected from other entrepreneurs and incubators for example.

## 7. DISCUSSION

The following section will discuss the conclusions, the study's contribution to knowledge and the research limitations of the results. Finally it will present suggestions for further research.

### 7.1 Discussion of Conclusions

To conclude, the study showed that most of the critical factors could be explained due to information asymmetries from the implication of how to allocate control within contracts. The result further supports that trust is identified to be the most important factor, both having a substitutive and complementary role to the other theories.

However, an important consideration of the drawn conclusions is that they are underpinned by personal experiences that can be interpreted differently depending on context and it is therefore hard to measure their validity, compared to in a quantitative studies. Another reflection is the fact that the negotiation process is a simultaneous process, whereas it is hard to distinguish factors that are interlinked in such an extent. The negotiation process intersects other disciplines as psychological and emotional aspects, which also are hard to quantify but however has a great impact.

Nevertheless, in accordance to the applied interpretive approach these influencing factors can be expected, and is therefore considered as a likely outcome of this type of study.

### 7.2 Contribution to Knowledge

The purpose of the study was to distinguish critical factors in the negotiation process between investors and entrepreneurs. The empirical contribution of this study is hence the investigation of the merged areas of the negotiation process and the relationship between entrepreneurs and investors for being able to condense critical factors.

This contributes to an understanding of how to handle critical phases in the process and reduce unnecessary complexity in the future; resulting in the number of cancelled deals due to misperceptions between the parties can be reduced.

Furthermore the study contributes with findings in a Swedish context, which is in contrast to the majority of the previous research which is accomplished abroad.

The theoretical contribution of this research is the creation of the theoretical framework where both agent-principal theory, trust and power were analysed simultaneously in order to investigate the intersection of the negotiation process and the investor-entrepreneur relationship. As earlier stressed in the literature by Shepherd & Zacharakis (2001), trust and control have been found to be needed to be considered simultaneously in order to understand the investor-entrepreneur relationship. This study fills this gap by addressing these theories simultaneously in order to conclude critical factors. The findings which concluded that trust was the most important critical factor in the negotiation process further emphasizes the need to further investigate the impact of trust in the relationship between investors and entrepreneurs. Hence is another contribution the illustration of the importance of trust which provides a direction for further research.

### 7.3 Limitations of Conclusions

When discussing the study it is relevant to consider the limitations of the conclusions. A primary limitation of the study is that the results build upon a small case study. Hence, conclusions are drawn based on a small set of empirics. In order to be able to draw more generalized conclusions more comprehensive studies are needed. Furthermore, interviews have been performed with individuals having different companies and experiences from different types of negotiations.

The implications of this is that it is harder to generalize the conclusions and apply these in other contexts.

Besides, there is a distinguishable difference between private equity and venture capital firms' negotiations in the respect that they are investing in different phases of the companies' life cycles. The lack of a fully homogenous perspective could therefore have affected the information receiver. However, this and the fact that interviewing entrepreneurs from various industries is not deemed to have affected the credibility of the results to a large extent, since the study aimed to identify critical factors for all negotiations between these two parties.

## 7.4 Suggestions for Further Research

For further studies it would be interesting to conduct similar and more extensive studies, including a larger set of empirics, which regards to study, and also observe more negotiations and interviewees. Such a study would facilitate research into additional critical factors, and generate more generalizable results. Furthermore, studies of the negotiation process between entrepreneurs and investors need to be increasingly studied over time to gain a more comprehensive understanding of the whole process.

Another area for future research is to further investigate the impact of trust in the negotiation process in the entrepreneur-investor relation since this was shown to have the greatest influence on the critical factors and has furthermore been much less investigated within the theory compared to the much more applied agency theory.

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## APPENDIX

### 1. Definition of Negotiation Process

When formulating our interview questions, we applied theories from literature regarding negotiation processes for businesses. Firstly, we defined phases of the process according to literature and used the one that were most similar to what we expected from our interviews. Thereafter, we compiled our interview survey. Since we used a semi-structured approach, these questions has only aimed to function as a base for our interviews, and the interviews have differed depending on the interview objects characteristics and experiences.

The following describing section only aimed to serve as a foundation and to set a frame of references of how we initially viewed the process.

Definition of the different phases (Rosell & Lundén, 1998)

1. Contact phase
2. Preparation and planning phase
3. Greeting phase
4. Introduction phase
5. Argumentation phase
6. Compromise phase
7. Ending phase
8. Implementation phase

#### 1. Contact phase

There are many ways for entrepreneurs and investors to get in contact, e.g. through networks, fairs and seminars.

#### 2. Preparation and Planning Phase

Critical for a successful negotiation is to plan and prepare in advance.

Some argue that the result of a negotiation depends up to 70 % on how well prepared the negotiators are before they enter the negotiation.

The remaining 30 % depends on how professional the persons act in the negotiation process. Therefore, the time spent before a negotiation is often very valuable for the outcomes of the negotiation. Many negotiators depend on their common sense, and do not prepare enough.

Every negotiation is unique and its essential to decide what primary goals that are desirable to accomplished and why, before even entering the negotiation. The goals can preferably be divided into three different levels:

- 1) What is the most desirable outcome
- 2) What is considered as a fair and reasonable outcome
- 3) What is the lowest acceptable level of outcomes

### *Strategy*

“Formulate your strategy to reach the second level, achieving a reasonable and fair result, but strive to accomplish the most desirable outcome” is a common rule of thumb in negotiation theories (Unt, 2007). Deciding the lowest acceptable level is important to remain persevering in the negotiation, but for him/her to never ever go beyond what he/she considered as acceptable. A very important psychological factor in the negotiation process that distinguishes good negotiators from not so good, is to be able to leave the negotiation table when passing this acceptable level.

A rule-of-thumb is that the goal setting should leave room for the counterpart to make a good business as well, a future good relationship is often build upon the fact that both parties left the negotiation table satisfied.

### *Goal Setting*

To achieve the main goals it is critical for the negotiator to structure the way to reach these goals by ranking milestones. Preferably these goals can be divided into how important they are relatively to each other. One way of doing this is to estimate how important these milestones are, how they will affect the outcome in a short- and long-term perspective and put a number on their importance. This can often be very helpful in the negotiation process in situations when the person will have to compromise to the counterparty.

Often it can be valuable to set alternative goals if the counterparty has another strategy. The more different alternatives, the more powerful position the negotiator can achieve.

### 3. Greeting Phase

Creating trust is essential for the entire negotiation process; often it is recommended to talk about daily, more unimportant subjects, before stating the negotiation. How the initial contact take place is said to be even more important in international situations where the cultural manner is different.

### 4. Introduction Phase

Start out with identifying the purpose with the negotiation; what is the primary goal with participating in this negotiation and to make sure both parties negotiate with similar intentions. A good rule-of-thumb can be to start out each negotiation with a summary of the current status. During the negotiation it can be preferable to use an agenda to structure the negotiation. The introduction phase primary aims to create opportunities for a future good collaboration.

### 5. Argumentation Phase

In this phase both parties usually try to show their negotiation power, who will have the best competitive advantage? What often define a good argumentation is that both parties use professional argumentation, is consistent but also compromising and listening and tries to understand what the other party want to accomplish. A tip giving to negotiators is often not give up any of his/her goals during this phase, it mostly aims to test the counterparty and understand his/her intentions.

### 6. Compromise Phase

A golden rule is to *“never give, without getting”*, meaning never compromising without asking for something in return.

### 7. Ending Phase

When reaching a complete solution that both parties are satisfied with, the negotiation is about to end. Sometimes it can be problematic to decide when both parties are satisfied enough, and what to remember is that no agreement is fulfilled until the contract is signed of both parties.

#### 8. Implementation Phase

Often, the negotiation process is only a beginning of a long-term relation and it is important to build a ground for a future good partnership.

## 2. Interview questions

### Fas 1: Förberedelsefasen

1.
  - a) Hur förbereder du dig inför en förhandling?
  - b) Hur sätter du strategiska och finansiella mål?
  - c) Vilka är dina viktigaste mål?
  
2.
  - a) Vilken information är mest relevant att erhålla gällande entreprenören/investeraren?
  - b) förhandlingsbeteenden
  - c) om motparten inlett förhandlingar med andra?
  - d) angelägenhet om ett samarbete?
  
3.
  - a) Hur går du tillväga för att samla in information?
  - b) Vilken typ av information är mest värdefull?
  - c) Vilken typ av information är mest svåråtkomlig?
  
4. Hur mycket tror du dina förberedelser påverkar förhandlingens utfall?

### Fas 2: Strategiska resonemang inför en förhandling

5. Hur formulerar du en strategi inför en förhandling?
  
6. Till vilken grad väger du in motpartens mål när du formulerar en strategi?
  
7. Sätter du upp alternativa mål, i så fall, hur går du tillväga för att formulera dessa?
  
8.
  - a) Vilka ytterligare faktorer, utöver affärsidén, utvärderar du vid en potentiell investering och hur värderar du dessa?
  - b) Inflytande/ Kontroll
  - c) Andel
  - d) Driv, engagemang
  - e) Kompetens

- f) Hur rankar du dessa relativt mot varandra?
9. a) Hur värderar du dina egna tillgångar i form av  
b) Kompetens?  
c) Nätverkskontakter?  
d) Ditt engagemang
10. a) Hur ofta händer det att du inleder en förhandling som inte avslutas på grund av oenigheter?  
b) Vilket skede i processen är mest kritiskt?  
c) Varför?
11. Hur mycket anser du att förhandlingsprocessen påverkar det fortsatta framtida samarbetet?
12. Upplever du några återkommande problem i förhandlingsprocessen?
13. Vilka förbättringsområden inom förhandlingsprocessen anser du finns?