



**Issue 2 – June 2007**

## **RICAFE2 Newsletter**

Welcome to the second edition of RICAFE2 newsletter. This newsletter aims to keep you informed of the recent developments in the RICAFE2 project.

<http://www.lse.ac.uk/RICAFE.htm>

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### **RICAFE2 - Regional Comparative Advantage and Knowledge Based Entrepreneurship**

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A project financed by the European Commission, DG Research  
under the 'Citizens and governance in a knowledge-based society' (FP6) programme  
Contract No : grant CIT5-CT-2006-028942.

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## **Second RICAPE2 Conference - Call for papers announced**

**RICAPE2 Second Conference**

**5 & 6 October 2007**

**Baltic International Centre for Economic Policy Studies**

**Stockholm School of Economics in Riga**

### **CALL FOR PAPERS**

The RICAPE2 Second Conference will be held on 5 & 6 October at the Stockholm School of Economics in Riga, Latvia. The organizers invite submissions for empirical and theoretical papers on the ability of financial systems to provide financing for knowledge-based entrepreneurial firms, on the influence of venture capital on firms' ability to translate technological advances into successful products, and on the contribution of knowledge-based entrepreneurship to regional dynamics. The topics we are planning to discuss include, but are not limited to:

- The choice between alternative sources of financing for innovative firms and their impact on strategic decisions in entrepreneurial firms;
- The determinants of knowledge-based entrepreneurship;
- Venture capital, its contribution to the knowledge-based economy;
- Economics of intellectual property rights and its implications for knowledge-based entrepreneurship;
- The role and design of financial contracts and of the choice of organizational form in fostering knowledge-based entrepreneurship;
- Effects of regulation on venture capital investment and on entrepreneurial dynamics;
- The impact of corporate governance mechanisms on the performance of entrepreneurial firm;
- The contribution of knowledge-based entrepreneurship to regional comparative advantage;

The conference proceedings will not be published, as we aim to attract papers on their way to publication in high quality journals.

**Expenses:** Travel (economy class round-trip) and accommodation expenses will be covered for presenters and discussants.

**Programme Committee:** Erik Berglof (European Bank for Reconstruction and Development), Marco Da Rin (Tilburg University), David Hsu (Wharton School, University of Pennsylvania), Josh Lerner (Harvard Business School), Branko Urošević (Belgrade Laboratory for Quantitative Finance), Alf Vanags (BICEPS, Latvia), Uwe Walz (CFS), Harry Yuklea (TECHNION).

**Deadline for submission of papers:** 20 June 2007.

Submissions are accepted online only via the RICAPE2 website: <http://www.lse.ac.uk/ricafe>.

The authors of selected papers will be informed by the end of July.

# **RICAFE2 Working Papers**

## ***Publication of the first set of working papers for Theme 1***

The RICAFE 2 research programme was designed along 3 main themes:

1. Analysis of the societal, legal, and economic factors that determine the forms and intensity of KBE.
2. Analysis of KBE's contribution to shifting patterns of regional comparative advantage.
3. Policy Implications

We are pleased to announce the publication of the first set of working papers for Theme 1 :

### **1) RICAFE Working Paper No. 038**

**Title:** Job-back Guarantees

**Authors:** Frédéric Palomino (HEC Paris) and Eloïc-Anil Peryache (HEC Paris)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP38-Palomino.pdf>

### **2) RICAFE Working Paper No.029**

**Title:** How Entrepreneurs Use Symbolic Management to Acquire Resources

**Authors:** Christoph Zott (INSEAD) and Quy Nguyen Huy (INSEAD)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP29-Zott.pdf>

### **3) RICAFE Working Paper No. 033**

**Title:** Schooling, Capital Constraints and Entrepreneurial Performance: The Endogenous Triangle

**Authors:** Simon Parker (University of Durham) and Mirjam van Praag (University of Amsterdam).

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP33-Parker.pdf>

### **4) RICAFE Working Paper No. 035**

**Title:** Favouritism in Capital Allocation

**Authors:** Mariassunta Giannetti (Stockholm School of Economics) and Xiaoyun Yu (Kelley School, Indiana University)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP35-Giannetti.pdf>

### **5) RICAFE Working Paper No. 036**

**Title:** Financial Contracting with Optimistic Entrepreneurs: Theory and Evidence

**Authors:** Augustin Landier (New York University) and David Thesmar (HEC, Paris)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP36-Landier.pdf>

#### **6) RICAFE Working Paper No. 030**

**Title:** The Circulation of Ideas in Firms and Markets

**Authors:** Thomas Hellmann (University of British Columbia) and Enrico Perotti (University of Amsterdam and CEPR)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP30-Hellmann.pdf>

#### **7) RICAFE Working Paper No.034**

**Title:** A Breath of Fresh Air? Firm types, Scale, Scope and Selection Effects in Drug Development

**Authors:** Ashish Arora (Carnegie Mellon University), Alfonso Gambardella (Bocconi University, Milan), Laura Magazzini (University of Verona) and Fabio Pammolli (University of Florence and IMT – Lucca Institute for Advanced Studies)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP34-Arora.pdf>

#### **8) RICAFE Working Paper No. 031**

**Title:** In Letter but not in Spirit: An Analysis of Corporate Governance in the UK

**Authors:** Sridhar Arcot (Financial Markets Group, London School of Economics) and Valentina Bruno (Financial Markets Group, London School of Economics)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP31-Arcot.pdf>

#### **9) RICAFE Working Paper No.032**

**Title:** Innovation and Venture Capital Exits

**Authors:** Armin Schwienbacher (University of Amsterdam and Catholic University, Louvain).

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP32-Schwiebacher.pdf>

#### **10) RICAFE Working Paper No.037**

**Title:** Who Chooses whom? Syndication, skills and reputation

**Authors:** Tereza Tykvová (Centre for European Economic Research (ZEW))

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP37-Tykvova.pdf>

#### ***Other RICAFE2 Working Papers***

The following working papers were also included in the RICAFE2 Working Paper Series

#### **RICAFE Working Paper No. 039**

**Title:** The Importance of Trust for Investments: Evidence from Venture Capital

**Authors:** Laura Bottazzi(Bologna University and IGIER), Marco Da Rin(Tilburg University, ECGI and IGIER) and Thomas Hellmann(University of British Columbia)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP39-Bottazzi.pdf>

**RICAFE Working Paper No.040**

**Title:** Evolution of Decision and Control Rights in Venture Capital Contracts: An Empirical Analysis

**Authors:** Carsten Bienz(Norwegian School of Economics and Business Administration, FMG-LSE and CFS) and  
Uwe Walz(University Frankfurt and CFS)

**Web address:** <http://www.lse.ac.uk/collections/RICAFE/pdf/RICAFE2-WP40-Bienz.pdf>

***1st RICAPE2 Annual Conference Papers***

The papers presented in the First RICAPE2 Annual Conference that took place in the London School of Economics on 5-6 October 2006 are now available from the RICAPE2 website:

<http://www.lse.ac.uk/collections/RICAFE/newsAndEvents.htm#generated-subheading6>

## Completion of First Annual Report:

In April 2007 we completed the first annual report of the RICAFE2 project. This included:

- A progress update on the research work completed so to the end of March 2007
- A State of the Art Report with Review of the Literature on Regional Comparative Advantage and Knowledge Based Entrepreneurship.
- The first set of working papers under Theme 1.

### *Executive summary of First Annual Report.*

Both at the national and at the Community level, policy-makers are finding it hard to foster KBE as a tool to improve regional growth, contribute to a smooth integration of accession countries, improve social cohesion, and make Europe more competitive vis-à-vis dynamic growth regions in emerging economies. The RICAFE2 project will contribute mainly suggestions for policy developments for strategic dimensions:

1. The main strategic dimension concerns how to improve the competitiveness and social cohesion of European regions by exploiting Europe's untapped KBE potential. Our results will provide policy-makers and industry leaders with suggestions for dealing with non-European high-growth regions. The insights and data gathered from in India and Israel, where we have a local presence, will address these issues and provide insights of the role of KBE in very different contexts;
2. A second strategic dimension concerns the economic and social disparities among regions in Western Europe and those in accession countries, and the difficulties of achieving integration by fostering regional KBE potential.
3. A third strategic question is both controversial and crucial for the future of Europe: how can policies directed at KBE contribute to managing the tensions generated by regional economic inequality? As the enlargement process advances, disparities across European regions naturally increase, and put social cohesion to a difficult test. Can policies directed at KBE play a positive role in this respect, or are they bound to accentuate the diverging paths between successful and unsuccessful regions?

The project's publishable results include a comprehensive report on how societal, legal, and economic factors affect the patterns of regional economic growth and how Knowledge-Based Entrepreneurship (KBE) contributes to shifting patterns of regional comparative advantage and to regional growth and social cohesion. Its deliverables are organized around three main themes:

- 1. Analysis of the societal, legal, and economic factors that determine the forms and intensity of KBE.**
- 2. Analysis of KBE's contribution to shifting patterns of regional comparative advantage.**
- 3. Policy Implications**

The RICAFE2 project has completed its first year of activity. Overall it has been a very fruitful year with both data collection and analysis of the data proceeding apace. We have also developed theoretical models to help in our future analysis. Most of the work during the year pertains to Theme 1 of the project.

The report below summarises our work during the year (the proceedings of the conference are presented in the Annexure 2) which was mainly focused on Theme 1. In what follows we describe the deliverables briefly and the major results from those: -

- The work performed so far furthers our understanding of the entrepreneurial process and based on our studies we have very interesting results to report. Based on a two-year inductive field study we find that entrepreneurs are more likely to acquire resources for new ventures if they perform symbolic actions. The data shows that entrepreneurs who perform a variety of symbolic actions skilfully and frequently obtain more resources than those who do not. In particular, we identify four symbolic action categories that facilitate resource acquisition: conveying the entrepreneur's personal credibility, professional organising, organisational achievement and the quality of stakeholder relationships.
- We analyse using a simple framework the development and financing structure of projects when potential entrepreneurs are risk averse. While the management literature has long recognized the impact of risk on the decision to become entrepreneur or intrapreneur, the current economic literature on entrepreneurship mainly assumes that would-be entrepreneurs are risk-neutral agents who approach investors because they are wealth constrained. The concern for risk allows us to consider the use of another type of insurance at the contracting stage: the offer of a *job-back guarantee*. In France, since 1985, offering such a guarantee is mandatory and firms have to reintegrate their employees within two years following their leave (labour Code, Art L 122-32-12 and followings). Besides, analysing the contractual implications of such guarantees, we show that the job-back guarantees can strictly increase the investment of agents in generating ideas and that, in the case of heterogeneous agents, leaving firms full discretion over the offer of job-back guarantees increases the informational efficiency of the labour market.
- In a further study we provide evidence (based on survey data from the Netherlands) that small business performance is affected by the human capital of the entrepreneur. We find that human capital as measured by number of years of education, increases entrepreneur's earnings by a direct 13% for each additional year of education whereas the indirect effect of education on earnings, via the capital constraint is another 4%. Thus, the power of extra education to improve entrepreneur's performance seems to be greater when capital constraints exist, because education helps to relax these constraints as well as having a direct effect on performance.
- We further explore the characteristics of entrepreneurs and question as to why entrepreneurs start new businesses? Surprisingly, we find that entrepreneurs do not start new businesses because it is profitable, but because they wrongly believe it is. In other words, entrepreneurs are typically over-optimistic about the success of their venture. We corroborate the analysis by using data from two waves of survey conducted by the French statistical office on a population of entrepreneurs the very year their business was started. We find that indeed the data supports our contention. In particular, we find that entrepreneurs with higher education and those who are developing their "own

idea” tend to be more optimistic, whereas entrepreneurs who take the business over from someone else tend to be less optimistic.

- Using a theoretical model we explore the role of favouritism and connections in entrepreneur’s ability to raise capital. We find that if the pool of savings is small, favouritism can lead to an efficient allocation of investment. As the economy develops and its pool of saving increases, information production and the identification of distant investment opportunities become crucial for efficient investment decisions. Nevertheless, even in such an economy favouritism can emerge and investors may find it optimal to fund low quality entrepreneurs if they are familiar with them. One way to mitigate favouritism and improve the efficiency of capital allocation is to increase the amount of disclosure by firms.
- In a separate but related set of studies we document in detail the effect of corporate governance regulations on disclosure by firms. Using the UK as a setting, since it follows the voluntary “comply or explain” approach to corporate governance we find that companies choose to comply rather than explain deviations from best practice. We further find that amongst those companies providing an explanation very few provide a good explanation related to their own circumstances. In most cases the explanations provided are standard explanations with very little information. Further analysis suggests that those companies providing good explanations out-perform all other companies and even those that comply. This suggests that indeed good firms disclose more and the same is reflected in their performance.
- An important question related to KBE is what kind of organisation is better suited for innovation firms or markets. We find that markets are better in developing ideas and leading to their commercial exploitation. However, in markets it is easier to steal ideas and they may deny the inventor a sufficient reward for invention. On the other hand firms can ensure that ideas are not stolen and the inventor is suitably rewarded for his invention, but keeps the idea within the firm and thus establishes a firms trade secret. Thus both firms and markets truly complement each other, each compensating for the inefficiency of the other. Firms incubate ideas, while markets increase their chances of elaboration. This complementarity suggests a natural symbiosis of open firms and markets.
- A related question is whether innovation is better performed in a large or small firm. The discovery of recombinant DNA was thought to have heralded the era of biotechnology in the pharmaceutical industry. Many thought this would lead to a spate of entry which would unleash widespread changes in the structure of the pharmaceutical industry. Though much has changed in the pharmaceutical industry, entrants have been a breath of fresh air rather than the gale of creative destruction that some foresaw. Using the pharmaceutical industry as a test ground we find that overall research scale (or size) at the firm level increases the likelihood of success though the effect at the firm level is negligible in magnitude. Further, existing big pharmaceutical firms are more likely to succeed in developing new drugs than new entrants. Finally, over time because of learning and other environmental factors new entrants become similar to more established firms.
- In the next paper we address the important issue of financing KBEs. In a theoretical model we investigate the phenomenon of syndication, which is a long existing feature of venture capital financing. We show that experienced partners may finance with either other experienced investors, to raise the success of the project or with other unskilled investors so that they can gain knowledge.



- Finally, we analyse how KBEs choose their innovation strategy and its interaction with the investor's exit preferences. The analysis provides key insights for the links between innovation, venture capital exits and market structure. A novel feature of the analysis is the inclusion on product market characteristics. Based on the product market strategy we study the entrepreneur's motivation to innovate so as to try and retain control of the project after the investor exits.