Pacific-Basin Finance Journal 29 (2014) 121–145

Contents lists available at ScienceDirect

Pacific-Basin Finance Journal

journal homepage: www.elsevier.com/locate/pacfin

Do venture capitalists play a monitoring role in an emerging market? Evidence from the pay–performance relationship of Chinese entrepreneurial firms ☆

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ARTICLE INFO

Article history:
Received 29 April 2013
Accepted 20 April 2014
Available online 26 April 2014

JEL classification:
G32
G34

Keywords:
Venture capital
Disproportionate ownership
Pay–performance relationship
Agency problems

ABSTRACT

This paper investigates venture capitalists' monitoring of managerial behavior by examining their impact on CEO pay–performance sensitivity across various controlling structures in Chinese firms. We find that the effectiveness of venture capitalists' monitoring depends on different types of agency conflict. In particular, we find that venture capital (VC) monitoring is hampered in firms that experience severe controlling-minority agency problems caused by disproportionate ownership structures. We provide further evidence that VC is more likely to exert close monitoring in firms that have greater managerial agency conflict, and thus require more direct monitoring. However, controlling-minority agency problems have a greater impact on VC monitoring than managerial agency problems. Overall, our study suggests that venture capitalists' monitoring role is hampered in an emerging market where firms have complex ownership structures that contribute to severe agency conflict between controlling and minority shareholders.

1. Introduction

Conventional wisdom indicates that venture capital (VC) investors, who typically make a profit by funding, monitoring, and then exiting entrepreneurial companies, tend to be specialists in developing and monitoring new ventures. Engel et al. (2002) find that venture capitalists directly monitor managerial

☆ We received valuable comments from Huasheng Gao, Kai Li, Douglas Cumming, Dai Na, Wei-Huei Hsu, Jo-Ann Suchard, Josh Lerner, Ronald Masulis, Terry Walter, and participants at the 2011 China International Conference in Finance, the Asian Finance Association (AsianFA) 2011 International Conference, the Durham Conference on the Chinese Capital Market 2011, and the Workshop on Venture Capital and Private Equity in the Asia Pacific Region in 2010.

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http://dx.doi.org/10.1016/j.pacfin.2014.04.005

behavior, documenting that firms with greater VC involvement display a weaker pay–performance association than comparable companies. Strong VC oversight substitutes for the pay–performance relationship, since managers are directly monitored by venture capitalists. In comparison, entrepreneurial firms without VCs may have to rely on various performance measures in annual compensation grants to incentivize CEOs. Barry et al. (1990) also find that venture capitalists play a key role in monitoring top management in entrepreneurial firms that are characterized by high-risk and high-growth opportunities, indicating that more direct monitoring is required when the classic managerial conflict described by Jensen and Meckling (1976) is more severe.

However, the existing literature of VC monitoring and its impact on the CEO pay–performance relationship (Engel et al., 2002) is only based on US firms where shares are usually diversely held by shareholders. There is no evidence to suggest whether VC monitoring will still be effective in emerging markets, where firms have more concentrated ownership structures. Previous studies show that in the corporate world outside the US and UK, ownership is usually concentrated in the hands of a few controlling shareholders through complex ownership structures (La Porta et al., 1999; Claessens et al., 2000). For example, in most emerging economies, where legal protection for shareholders can be weak, large controlling shareholders usually control listed firms through disproportionate ownership structures (Faccio et al., 2001, 2010; Lin et al., 2011, 2012). In previous literature, such disproportionate ownership structure is associated with severe agency conflict between controlling and minority shareholders because controlling shareholders of those firms usually have an incentive to expropriate the interests of minority shareholders (Lemmon and Lins, 2003; Maury and Pajuste, 2004; Gompers et al., 2010; Lin et al., 2011, 2012). It is therefore reasonable to expect that effective VC monitoring may be hampered because controlling shareholders in these firms have strong incentives and the ability to transfer corporate resources for private benefits at the expense of other investors, including venture capitalists (Lin et al., 2011).

In this paper we investigate venture capitalists' monitoring role in an emerging market by examining their impact on the CEO pay–performance relationship and how the strength of their monitoring is influenced by agency conflict between controlling and minority shareholders. In particular we examine: (1) whether venture capitalists' direct monitoring reduces entrepreneurial firms' reliance on performance-based contracts; (2) whether venture capitalists' monitoring role differs in firms with different levels of agency conflict between controlling-minority shareholders; (3) whether VC plays a monitoring role in firms with greater managerial agency problems, which have greater need for monitoring; (4) whether controlling-minority agency problems have greater impact on venture capitalists' monitoring than managerial agency problems; and (5) whether non-state-funded and state-funded VC have a similar incentive to monitor.

We conduct our research using a sample of Chinese entrepreneurial firms due to their specific controlling structures. More specifically, Chinese entrepreneurial firms have a controlling structure characterized by the ubiquitous presence of the disproportionate ownership structures. As indicated by Fan et al. (2011), disproportionate ownership structure is an important institutional factor that influences firms' corporate finance and managerial behavior in an emerging market, such as the Chinese capital market. Previous studies have shown that with disproportionate ownership structures, the controlling shareholders always have a strong incentive to expropriate the interests of other investors, including venture capitalists, because they obtain all the private benefit without bearing the full consequences (Lin et al., 2012). This means that a disproportionate ownership structure results in severe agency conflicts between controlling and minority shareholders (Claessens et al., 2002; Faccio and Lang, 2002; Faccio et al., 2010; Wei and Zhang, 2008; Lin et al., 2011; Liu and Tian, 2012). It is therefore interesting to examine whether VC monitoring is strengthened or weakened by the severe controlling-minority shareholder agency conflicts caused by disproportionate ownership structures. We exclude state-owned enterprise (SOEs) for the following two reasons. First, the assumption underlying our analysis is that firms tend to adopt performance-based compensation to incentivize managers. However, CEOs in SOEs are usually paid based on their official ranking rather than their performance given that managers are nominated by the government to pursue the government's objectives rather than maximizing value (Fan et al., 2007). Therefore a weaker pay–performance relationship does not necessarily reflect the stronger role of VC monitoring.[1]

[1] We appreciate the reviewers' comment and suggestion on this issue.