Venture capital, corporate governance, and financial stability of IPO firms

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This study investigates the effects of venture capital investments on corporate governance and financial stability of IPO-firms in the emerging markets. We find that VC-backed firms have less agency problems related to excess control than non-VC-backed firms at the time of IPO, and venture capitalists are more likely to improve the excess control problem in firms with weak-governance-structure than those with strong-governance-structure. We also find that VC-backed firms are less likely to encounter financial difficulty than non-VC-backed firms. Taken together, VC investments play a role in mitigating excess control and providing positive financial stability in the emerging markets.

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1. Introduction

Prior research reports that ownership concentration is often found in emerging markets because they have a large number of firms controlled by a small number of controlling shareholders (Claessens et al., 2000; Faccio and Lang, 2002; La Porta et al., 1999). Ownership concentration is normally regarded as an institutional arrangement that facilitates transactions in a weak property rights environment. In such an ownership concentration environment, controlling shareholders have the power and the incentive to negotiate and enforce corporate contracts with various stakeholders. According to Shleifer and Vishny (1997), the benefits for the controlling shareholders are larger in markets that are less developed, or

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where property rights are not well defined or protected by judicial systems. However, concentrated ownership contributes to serious agency problems (Gibson, 2003). Tight ownership control is likely to create an entrenchment problem that allows self-dealings by the controlling shareholders to go unchallenged internally by the board of directors or externally by the takeover market. This entrenchment problem can sometimes come at an expensive price to these firms. For example, prior studies find that, in a weak legal environment with limited protection of minority rights, controlling shareholders can expropriate minority shareholders and create harm to the value of the firm (e.g., Claessens et al., 2002; Lins, 2003; Yeh and Woidtke, 2006). This is so particularly when the controlling shareholders use the pyramidal structures to obtain voting rights in excess of their cash flow rights. This type of agency problem is widely known as “excess control” by controlling shareholders.

Given the problem with rising ownership concentration in the emerging markets, a general concern thus arises as to whether there are alternative governance mechanisms available to improve corporate governance and protect minority shareholders. Prior research examining the effects of VC investments on corporate governance documents that venture capitalists can add value to new IPO firms not only in financing but also in improving corporate governance through board compositions, CEO turnover, and monitoring systems (Campbell and Frye, 2009; Hellmann and Puri, 2002; Kaplan and Stromberg, 2003; Lerner, 1995). However, so far little evidence is available regarding the effectiveness of VC investments in mitigating the serious agency problem related to excess control and maintaining financial stability of VC-backed firms after initial public offerings. Therefore, the purpose of this study is first to examine the effect of VC investments on mitigating the agency problem of excess control resulting from ownership concentration in the emerging markets. Furthermore, given the fact that venture capitalists may retain their investments for significant periods of time after the IPO (Barry et al., 1990; Hochberg, 2008), we also investigate whether venture capitalists are effective in ensuring healthy financial stability of their portfolio firms after initial public offerings.

In order to empirically examine the effectiveness of VC investments in mitigating the extent of excess control and ensuring healthy financial stability of IPO firms, we focus our analysis on VC investments in IPO firms in Taiwan emerging markets. Taiwanese experience in VC investments offers several advantages as a suitable setting to examine our research questions proposed in this study. First, similar to most emerging markets, Taiwan has a corporate governance environment with weak protection of minority shareholders, high ownership concentration, and predominance of family-controlled firms. Second, we focus our sample selection on the technology-based industry which is similar to the work of Lerner (1994). Lerner analyzes the relationship between venture capitalists and the decision to go public in the biotechnology industry because a homogeneous data sample permits more refinement of comparisons between VC-backed and non-VC-backed firms. In our study, VC investments in Taiwan are widely recognized as a major “technology-oriented” complex in the emerging markets. As presented later in the next section, both total amount and total number of VC investments in the technology-based industry stand at more than 70% of the total investments in Taiwan.

Our results in this study show that VC investments significantly mitigate the agency problem of excess control resulting from ownership concentration arrangements in the emerging markets. Furthermore, we find that venture capitalists are more likely to improve the governance problem of excess control in IPO firms with weak governance structure than those with strong governance structure. Finally, we find that IPO firms backed by VC investments are less likely to encounter financial difficulty or distress than those not backed by VC funds for 7 years after public offerings. Overall, our results indicate that venture capitalists add value to new IPO firms not only in financing capital needs but also in mitigating the agency problem of excess control. As a result, venture capitalists are able to ensure better corporate governance and healthy financial stability in their portfolio firms after initial public offerings.

This paper contributes to the growing literature that examines the important role of venture capitalists in improving the corporate governance and the agency problems of IPO firms in several ways. First, existing venture capital studies are generally focused on the impact of VC investments on the board structure and the corporate governance in IPO firms (Gompers et al., 2005; Kaplan and Stromberg, 2003; Kortum and Lerner, 2000; Lerner, 1999). Little evidence is available regarding the impact of VC investments on the ownership

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1 We obtain qualitatively similar results if using 5 years of window after the public offerings for the analysis.
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