Journal of Corporate Finance 18 (2012) 1143–1167

Contents lists available at SciVerse ScienceDirect

Journal of Corporate Finance

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

Entrepreneurs' financing choice between independent and bank-affiliated venture capital firms☆

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ARTICLE INFO

Article history:
Received 27 July 2009
Received in revised form 4 July 2012
Accepted 7 July 2012
Available online 20 July 2012

JEL classification:
D81
G21
G24
G32

Keywords:
Venture capital
Independent funds
Affiliated funds
Captive funds
Entrepreneurial finance

ABSTRACT

This paper analyzes how the affiliation of a venture capital firm affects the deal terms for innovative entrepreneurial ventures. We develop a theory to explain the advantages of independent and bank-affiliated venture capital funds for entrepreneurs. We assume that independent venture capital firms provide better support quality while bank-affiliated firms are less financially constrained. The entrepreneur selects the optimal contract by trading-off these characteristics. The model allows several empirically testable predictions concerning the nature of projects financed by either type of venture capital firm. Entrepreneurs should seek capital from independent or affiliated venture capitalists contingent on the degree of sophistication of their project, their liquidation value, the importance of expected management support, and the remaining time to fundraising.

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1. Introduction

It is important to understand the characteristics of various financing resources for start-up companies to determine the alternative that provides the largest benefits to an entrepreneurial venture. Venture capital (VC) is one of the financing resources and the expansion of the VC industry in recent decades has contributed to the emergence of entrepreneurial activity and professionally managed start-ups. Venture capitalists invest in potential high-growth companies, as well as provide management support, knowledge, experience, and access to networking opportunities.

We observe two principle types of VC firms. The dominant structure is the independent limited partnership. As comprehensively described (e.g., Sahlman, 1990), these VC firms tend to invest in particular industries, stages of company lifecycles, and geographic regions. In this type of organization, several institutional investors (the limited partners or LPs) commit capital to a closed-end fund vehicle with a limited lifetime, usually ten years. This fund is managed by the general partner (GP), the "venture capitalist." By legal definition, the LPs have no right to actively participate in the fund's management, resulting in a rather small influence on its particular investments. Once a fund is raised, activities start with an investment period, followed by a harvesting period. During the investment period, the venture capitalist seeks promising ventures. Within the harvesting period, the VC firm aims to decrease its exposure,

☆ We particularly thank Catherine Casamatta and an anonymous JCF referee for their recommendations and support. We are also grateful for important comments by Philippe Desbrières, Ulrich Hege, Antoine Renucci, Frédéric Loss, Laura Gonzalez, Matthieu Bouvard, and by our discussants at the 2009 FMA European Conference in Turin, the 2009 Midwest Finance Association meeting in Chicago, and the 2008 EFMA meeting in Athens.

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doi:10.1016/j.jcorpfin.2012.07.001

divest, and return the proceeds to the investors. A strong performance pressure arises as the GP must raise a subsequent fund to continue operations. However, the LPs will only commit new capital to the successor fund if they are satisfied with the firm's performance.

In parallel, there exist captive – or affiliated – VC funds, which are subsidiaries of larger firms and (often exclusively) manage capital of their parent bank, insurance company, other type of institutional investor, or large corporation. In the latter case they are called corporate VC firms. The capital source and the VC firm's affiliation play an important role because they affect the firm's investment strategy. Independent funds are driven by the requirement to deliver an appropriate investment return. Their investment rationale is purely financial, without a long-term strategic interest. However, affiliated VC firms can invest to pursue the strategic goals of their parent companies. The strategic perspective and access to the large capital pool of their parent firms without the need to raise follow-on-capital can reduce the pressure on captive funds to perform well. For example, Hellmann et al. (2008) empirically reveal that captive VC companies operate in the less risky stages of venture formation and that they are more interested in finding complementarities with other activities of their parent firm (e.g., traditional lending) than they are in the success of the venture.

This structural difference affects the relationship between an entrepreneur and either type of VC firm. An entrepreneur should be familiar with this difference and choose the type of VC firm that is able to provide her the largest benefit. In this paper, we propose a model to analyze how the contracts between innovative entrepreneurs and either type of VC firm vary. Our model reveals that, depending on the combination of the expected remaining time to fundraising, the exerted effort by the entrepreneur, the value-adding contribution of the VC firm, and of the venture's expected liquidation value, one of the two VC structures will be preferential. This result is relevant for entrepreneurial finance practice. It also allows the formulation of several empirically testable hypotheses.

We use the term “bank-affiliated VC” to represent all forms of captive funds except corporate venture capitalists. Corporate VC funds are unique with respect to several characteristics incorporated in our model and we interpret our results for corporate VC firms in a separate section of the paper. Our model is based on the principle that venture capitalists stage their investments to mitigate hazards.[1] This staged investment is made at two successive points in time. At the seed stage, the investor is either an independent or bank-affiliated venture capitalist. During the holding period, the VC firm obtains private information on the state of the venture and has to decide between selling, liquidating or continuing. The state of the project is either favorable or unfavorable and depends on the entrepreneur's effort. The entrepreneur determines her level of effort at beginning of the seed stage. Effort is costly, and the cost depends on the quality of support provided by the VC firm. We assume that this quality is higher in the case of an independent VC firm versus that of a bank-affiliated VC firm. When the venture reaches the expansion stage, it requires additional funding. We assume that this expansion capital cannot be provided by the same independent seed-financing VC firm, whereas the bank-affiliated venture capitalist has no financial constraints and is able to provide second round financing. Furthermore, the independent seed-financing venture capitalist might meanwhile need to initiate fundraising preparations, forcing the firm to divest the venture, even in a favorable state, for the purpose of presenting a successful track record to investors.

In this setting, we determine the first-best situation, in which the venture is liquidated in the bad state and continued in the good state. Next, we derive two equilibria, corresponding to two contracts that the entrepreneur may sign either with an independent or bank-affiliated venture capitalist. With the independent firm, a perfect Bayesian equilibrium is reached, which is either a pooling or a separating equilibrium situation. In the pooling equilibrium, the venture never gets liquidated because the investor benefits from his private information and sells his claims in a bad venture as claims in a good one. In the separating equilibrium, the contract allows the disclosure of the project's state to outside investors at the expansion stage. In fact, the investor is incentivized to do so. However, this equilibrium is only possible if the independent venture capitalist is not required to raise a new fund at that time and, hence, does not need to sell claims to present a successful track record to investors. Unfortunately, inefficiencies remain because the venture will not be liquidated in a bad state if the-seed financing investor initiates fundraising preparations. With a bank-affiliated venture capitalist, the moral hazard-problem does not exist because there is no need for an additional outside investor, and the VC firm's continuation decision replicates the first-best strategy. However, the equilibrium is not established at the first-best level because the quality of the bank-affiliated VC firm's support is assumed inferior to its independent counterpart's. The entrepreneur has to decide between two possible contracts according to the following rationale: she weighs the benefit of better support from an independent VC firm against the advantages resulting from the absence of inefficient continuations when contracting with a bank-affiliated venture capitalist.

Our analysis builds on an important consideration: VC firms provide capital, monitor their investees, support their development and strategy, help to recruit key employees, and much more. Our central assumption is that a bank-affiliated VC firm is less effective in its support than is its independent counterpart. This assumption is based on Bottazzi et al. (2008), who find that independent venture capitalists are more active than captive investors and that this increased activism results in a higher rate of successful exits.

The distinction between the two types of venture capitalists is also related to Hellmann (2002), who analyzes an entrepreneur's choice between an independent and a corporate VC firm. The independent VC firm's motivation is purely financial, while the corporate VC firm pursues strategic objectives that may cause conflicts of interest with the entrepreneur. Contingent on the characteristics of expected synergies, the entrepreneur should choose either an independent or a corporate VC firm, or a

[1] As highlighted by Sahlman (1990) and Kaplan and Strömberg (2003, 2004). For a theoretical discussion of staging, refer to Admati and Pfleiderer (1994), Gompers (1995), Cornelli and Yosha (2003) and Wang and Zhou (2004).

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