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The impact of venture capital on family businesses: Evidence from Spain

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ABSTRACT

We analyzed growth in family and non-family Spanish venture capital-backed firms. When the venture capital (VC) firm does not hold a majority stake, the usual risk aversion attitudes in family firms may lead to conflicts between the management cultures of the existing and new shareholders, which may affect growth. We found lower firm growth after the initial round in family firms only when the investor holds a minority stake. Our results may explain the under-representation of family firms in VC portfolios and highlight the need to align the objectives of family managers and VC investors before the initial VC round.

1. Introduction

Venture capital[3] (hereinafter, VC) represents an alternative source to finance investment opportunities for a wide variety of firms. The total amount committed in Europe rose from 3.4 billion Euros in 1988 to 43 billion Euros in 2010, with 5000 companies involved in 2010 (EVCA, 1988–2010). Even in a country such as Spain, from the decade of the 1990s when investments amounting to a few hundred million Euros were made in about one hundred firms per year (Balboa & Martí, 2004), the yearly amount committed is around 4 billion Euros since 2005, with around 800 investments per year and an existing portfolio at the end of 2010 amounting to 19 billion Euros invested in 3261 portfolio firms (Barthel & Alférez, 2011).

The huge increase in the amounts invested also shows a change in the role played by venture capitalists (hereinafter, VCs) in the investee companies in Spain, following a pattern found in most European countries. In the U.S., VC was originally related to minority investments in innovative companies at the founding or early development stage (Bygrave & Timmons, 1992). The minority share of VCs tried to avoid distorting the innovative drive of the entrepreneur, which could be justified from a resource base (Florin, 2005) or an agency theory (Sapienza & Gupta, 1994) perspective. Nevertheless, the poor performance of those investments in most European countries (e.g. see returns on early stage investments in performance reports focused on different European countries, such as NVP, 1998; Guillaume, 1998; BVCA, 1998, 2009; EVCA, 2005) has led to an increasing share of minority and majority stakeholdings in cash-generating companies mostly belonging to low technology industries (e.g. see EVCA Yearbooks, 1988–2010). In particular, 70% of the total amount invested and 15% of the number of investments in Europe were leveraged majority acquisitions (EVCA, 2010).

In addition to the funding provided, managerial support and other value-adding activities seem to explain the superior performance of VC-backed firms (Sapienza, 1992; Barry, 1994). In this respect, many papers have already addressed the issue of the positive impact that VC investors have on their investee firms (Alemany & Martí, 2005; Baum & Silverman, 2004; Belke, Fehn, & Foster, 2006; Davila, Foster, & Gupta, 2003; Hellmann & Puri, 2002; Manigart & Van Hyfte, 1999).

VC investors also invest in family-controlled businesses, which are the prevailing form of enterprise throughout the world (King & Santor, 2008; Mandl, 2008). The importance of family businesses in the literature has increased substantially in the last decade. Among the topics of interest, family firm growth and succession are recognized as the main challenges for family businesses. In this context, we argue that VC may facilitate firm changes in management, organization, governance and ownership to support the family firm's survival and future performance. But little attention has been paid in the literature to the effect of VC involvement in family firms. It is accepted that, on average, VC backing exerts a positive effect on investee firms. Nevertheless, the existence of different growth patterns in family and non-family investee firms has not been explored yet.

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[3] Under the term Venture capital we include investments at all stages, encompassing investments at the early, expansion and late stages.

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We aim to investigate to what extent the specific characteristics of family businesses cause higher or lower growth when compared to other investee firms without family-related control. Based on their determination to protect their socioemotional wealth (Gómez-Mejía, Haynes, Núñez-Nickel, Jacobson, & Moyano-Fuentes, 2007), we assume that family businesses are more reluctant to change their culture and managerial style, which is something to be expected as part of the value-adding services provided by VCs. Nevertheless, the willingness to accept new strategic and entrepreneurial goals may be affected by the minority or majority share held by the incoming external investor. Along these lines, we anticipate that VC investors are less able to provide managerial support when they hold a minority stake because the existing family management might be reluctant to accept changes in their own management culture. As a result, we hypothesize that they could perform worse than non-family investees.

Conversely, in family businesses where VC investors acquire a majority stake, they can impose their own management style and force deep organizational changes. Therefore, the evolution of family businesses that are subject to a majority acquisition should not be statistically different from that of other non-family firms with VC backing.

The scope of the paper comprises Spanish firms that were subject to a VC investment between 1995 and 2004, with our accounting data ranging from 1991 to 2007, whenever possible. By concentrating on data from only one country, we guarantee that all sample firms operate under similar constraints deriving from the institutional and legal environment (De Clerk, Sapienza, & Zaheer, 2008).

We contribute to the literature in two ways. Most studies on family firms are based on qualitative data, thus limiting the ability to measure the impact of sound organizational changes. In this work we base our analyses on objective quantitative data to test our hypotheses. We also contribute to the limited existing evidence on the effect of VC involvement in family firms (Debicki, Matherne, Kellermanns, & Chrisman, 2009), especially regarding key strategic decisions such as growth and succession.

The rest of our paper is structured as follows. In the following section we describe the role played by VCs in investee firms. We also present our hypotheses regarding the differential effect of VC investments according to the equity share they hold in investee family-controlled businesses. The third section concentrates on the description of the data and the models applied. The fourth section reports the results obtained, and the fifth is devoted to the conclusions and discussion of the main findings.

2. Family firms, venture capital and its impact on firm growth

2.1. Venture capital impact on firm performance and growth

VCs offer value-adding services to the investee firms (Jain, 2001), which are not provided by other financial intermediaries such as banks or savings banks. Screening and monitoring (Baum & Silverman, 2004; Chemmanur, Krishnan, & Nandy, 2011), in addition to managerial support and expert advice, explain the positive impact VCs have on investee firm performance (Balboa, Martí, & Zieling, 2011; Croce et al., in press; Davila et al., 2003; Hellmann & Puri, 2002; Sapienza, 1992; Zahra, 1995). Proactive initiatives to create direct connections with key external stakeholders are also main VC value-adding inputs (Large & Muegge, 2008). Kaserer, Achleitner, von Einem, & Schiereck (2007) summarize three areas for value creation in investee firms, namely operating/strategic value drivers, corporate governance and financial issues. The corporate governance issues include the reduction in agency costs, the mentoring activities undertaken to enlarge the network of business contacts, and the enhanced monitoring when VC firms hold a majority position.

The results of most empirical studies show that VC-backed companies outperform non-VC-backed ones. To cite a few, Davila et al. (2003) highlight employment growth in U.S. VC-backed firms. Manigart and Van Hyfte (1999) find higher growth in total assets and cash flow for Belgian venture-backed companies when compared to non-venture-backed ones. Engel (2002) also finds higher employment growth rates in German VC-funded firms. Bertoni et al. (2011) find similar results in Italian high-tech firms. Alemany and Martí (2005) find evidence of higher revenue, asset and employment growth in Spanish VC-backed firms.

Originally, U.S. VC investors focused on innovative companies that did not have access to traditional sources of funds to finance the startup and early expansion processes (Bygrave & Timmons, 1992). Asymmetric information problems are acute in those firms, thus limiting their ability to fund growth by accessing external financing sources. VCs are considered as specialized, informed investors able to address the serious information asymmetry problems found in those ventures (Chan, 1983). They exhibit outstanding screening abilities as well (Shepherd & Zacharakis, 2002; Tyebjee & Bruno, 1984). After the investment, VCs develop close relationships with entrepreneurs/managers and establish tight reporting and control systems in the investee firms (Scholtens, 1999).

Despite the high risk involved, VCs originally tended to hold minority stakes in those innovative early stage companies (Bygrave & Timmons, 1992) to avoid distorting the entrepreneurial drive of the managers. Minority shareholdings could be justified from two different angles. From a resource base perspective, Florin (2005) notes the importance of the relationship between founder characteristics and performance and recalls the general agreement about the idea that the founding team provides most of the experience and technological and organizational skills that drive a company's performance (e.g. see Bruno & Tyebjee, 1985; Dollinger, 1995; Dyke, Fischer, & Reuber, 1992; Siegel, Siegel, & MacMillan, 1993). From an agency theory perspective, Sapienza and Gupta (1994) point out that a significant reduction in ownership may reduce managerial incentive to work toward long-term profits.

Based on the information gathered in the screening process (Hisrich & Jancovicz, 1990; Rock, 1987) and the shareholders' agreement signed at the time of the initial investment round (Admati & Pfleiderer, 1994), VCs initially trusted the capability of the investee firm managers. In addition, close monitoring and frequent interaction between VC and investee managers are usual when VC investors hold minority stakes (Sapienza & Gupta, 1994), especially when firm managers have limited managerial experience (Rock, 1987). Therefore, VC investors tended to be confident about the managerial team's flexibility to accept their strategic and managerial guidance. In case this assumption proved to be wrong, VCs usually staged their commitments to preserve the right to abandon the project (Admati & Pfleiderer, 1994; Sahlman, 1990).

Since the late eighties, however, the investment strategy of VC institutions across Europe has been remarkably different from the original pattern followed by U.S. investors. As reported in the European Private Equity and Venture Capital Association (EVCA) Yearbooks (EVCA, 1988–2010), the bulk of investments is concentrated in consolidated, large companies, mostly belonging to cash-generating low technology industries. The amounts committed to early stage innovative firms rarely exceed 10% of the total amount invested. Since the leading managerial role in consolidated firms may be played by either internal or external experienced managers, it is more likely that VC investors prefer to hold controlling positions in those firms. Furthermore, the cash-