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Investment stage drifts and venture capital managerial incentives

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ABSTRACT

This paper investigates VC investment stage drifts as explained by the outcomes of managerial incentive schemes under different financial market conditions and past return performances. We exploit a unique dataset containing data for all of the venture capital funds in Europe that received financial support from the European Investment Fund (EIF) during the years 1998–2007. The dataset includes 149 VC funds that invested in 1925 companies. We find that a higher hurdle rate produces a compensation incentive that discourages VC managers from lowering funds' risk. We also observe that more reputable fund managers are less likely to increase risk by downward stage drifting and more likely to play it safe by following upward stage drifting strategies. Finally, managers of funds with a poor past performance appear to be less keen to perform stage drifts towards less risky stages, relative to well-performing fund managers. The latter evidence is more significant in periods of bull financial markets.

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1. Introduction

Venture capital (VC) funds often include in their portfolios companies whose characteristics do not fully reflect the funds' original and stated objectives in terms of investment focus. This investment practice, which is known as "style drift", can appear in several forms. VC funds can act inconsistently with respect to their stated investment objectives, in terms of firm size, stages of entrepreneurial firm development, sector, geography or technology intensity.

In general, limited partners of the VC funds perceive style drift as a sub-optimal investment practice. A deviation from the stated investment focus of the VC fund can potentially affect the risk/return profile of investors' portfolios. Given the long-term nature of VC investment and the lack of liquidity options, investors do not have an immediate possibility to exit their investment by withdrawing capital if they view style drift as unfavorable for the composition of their portfolio.

Inconsistency of investment style performed by VC funds is a relevant issue in today's fundraising environment. As reported in the survey "2012–2013 Global Private Equity Barometer" conducted by Coller Capital, a leading institutional investor in the private equity industry, style drift is the greatest concern for 73% of respondent limited partners (Coller Capital, 2013). Recent data on VC funds' stage drifts also point to the non-trivial relevance of the phenomenon. Among different types of drift strategies, Cumming et al. (2009) report that 56% of VC funds style drift are deviations from the stated stage focus of the fund. Investors that might want to have an allocation of their resources into high-risk high-return investments (e.g. by selecting an early stage focused VC fund) might be ending up with low-risk low-return investments in their portfolios (as a result of a drift of the VC fund's management team strategy towards later stage deals) and vice versa.

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As far as we know, the only paper that examines the specific issue of style drift in the venture capital market is the one by Cumming et al. (2009). Cumming et al. (2009) focus on development stage drifts, and they associate such style drift strategies to the opportunity of diversifying the portfolio of a specific VC fund. They suggest (and provide empirical evidence) that, ceteris paribus, less-established fund managers are more adverse to drifts, because they have stricter contractual limited partnership covenants imposed on their investment activities; moreover they also want to signal their loyalty to the stated objectives of the fund. The authors also find that style drifts are associated with investments that are more likely to yield favorable results in terms of exit strategy and that changes in market conditions between the time of fundraising and the time of investment affect the VC managers' propensity to style drift.

In this paper we add to the current limited evidence on style drift in the VC market by focusing on VC style drifts concerning entrepreneurial firms' development stages (investment stage drift, henceforth). We depart from Cumming et al. (2009)'s work mainly because we associate to investment stage drifts a specific risk shift direction. Considering the different risk characteristics of the investments at different development stages, and in particular the fact that risk is higher in earlier stages of development, we treat as *an increase in portfolio risk* every *downward drift* (i.e., investment in earlier stages, with respect to the stated investment focus) and, vice-versa, as *a decrease in portfolio risk* every *upward drift*. While Cumming et al. (2009) treat upward and downward drifts in the same strategic frame, we argue that stage drift should not be investigated without considering the direction of the drift. Given that the decision to drift directly results in a change of the portfolio risk, our idea is that upward or downward drifts cannot be explained by the same determinants.[1] By a theoretical perspective, we investigate in deeper detail to what extent stage drifts can be explained as outcomes of managerial incentive schemes from the literature on managerial risk taking in response to compensation, tournament and employment incentives for mutual funds (Brown et al., 1996; Chevalier and Ellison, 1997; Hu et al., 2011; Kempf et al., 2009). We depart and apply the conceptual framework drawn from this literature to the VC funds. While the first two incentives are associated with managers' search for higher compensation, the latter one is related to their fear of being laid off. The relative strength of these incentives, which drives risk shifting by fund managers, depends on the previous return performance, on the conditions of financial markets and on the level of public ownership.

The VC setting offers interesting insights because the monitoring effort of investors is, for obvious reasons, larger and more effective than for mutual funds (Croce et al., 2015; Cumming et al., forthcoming). Moreover, style drifts in VC funds can be easily and immediately recognized as deviations from the funds' stated objectives.

To understand the relationship between managerial incentives and risk taking in the form of stage drifts under different economic states and performance behaviors, we use a dataset of 149 publicly sponsored VC funds that received financial support from the European Investment Fund (EIF)[2] and that invested in 1925 European companies between 1998 and 2007. The primary advantage of the EIF dataset is the high reliability and the completeness of the information available on each deal. We have a definition of the VC funds' investment objectives in terms of business stages of development that should be more reliable than the ones provided by commercial databases, because information comes directly from official sources and documents delivered by the EIF to its shareholders. We have also "certified" and detailed data on contractual clauses, which allow us to assess accurately the managerial determinants of drifted deals.

Results highlight that managerial incentives affect VC managers' decisions to alter their risk profile. Consequently, upward and downward directions of the drifts are differently determined. In particular, we find that a higher hurdle rate produces a compensation incentive that discourages a VC fund's manager from lowering the risk. We also observe a positive and significant relationship between the level of management fees, which proxies for the reputation of VC fund managers, and the probability of upward stage drifting, while the opposite effect is found when considering the probability of downward stage drifting. Consequently, more reputable fund managers are less likely to increase their funds' risk by downward stage drifting and more likely to play it safe by following upward stage drifting strategies. Results also show that the extent of fund managers' risk adjustment in response to managerial incentives is contingent upon financial market conditions and past return performances. When stock markets are performing well, VC fund managers are more inclined to increase their funds' risk by downward drifting, independently of the incidence of public ownership. If financial market conditions are not favorable and public ownership is lower than 50%, VC fund managers tend to perform more upward stage drifts. Finally, managers of funds with a poor past performance appear to be less keen to perform stage drifts towards less risky stages, relative to well-performing fund managers. The latter evidence is more significant in periods of bull financial markets.

The remainder of this paper is organized as follows. Section 2 puts forward some testable hypotheses in the context of prior research. Section 3 introduces the dataset and the summary statistics. Section 4 presents the econometric models used and discusses the results. Section 5 concludes and summarizes the paper.

2. Hypotheses development

In this section we gain insight into the economic motivation for risk shifting by looking at several incentives that VC fund managers face. The conceptual framework offered by the literature on managerial risk taking in response to compensation incentives mainly focuses on the incentive schemes offered by contingent situations, contractual covenants and compensation profiles (Carpenter, 2000; Chakraborty et al., 2007; Chen et al., 2006; Coles et al., 2006; Rajgopal and Shevlin, 2002; Raviv and Sisli-Ciamarra, 2013; Ross, 2004). A

[1] Potentially, a stage drift might be observed when a misclassification of the development stage of the venture by the fund occurs or rather as an occasional decision to seize a specific investment opportunity. We will assess that drifts in our sample are not classification mistakes or random episodes.

[2] EIF is the European Union body specializing in SME equity financing. It is primarily owned by the European Investment Bank (62.1%) and the European Commission (30%). The remaining shareholding comes from public or private banks and financial institutions (7.9%). EIF conveys public financial resources into a large number of VC funds in Europe. Currently the EIF manages 250 VC funds, with net commitments of around 3 billion euros (www.eif.org).

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