J. Finan. Intermediation 18 (2009) 599–631

Contents lists available at ScienceDirect

J. Finan. Intermediation

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

Financial contracting with strategic investors: Evidence from corporate venture capital backed IPOs

Ronald W. Masulis [a], Rajarishi Nahata [b,*]

[a] Vanderbilt University, USA
[b] Baruch College, City University of New York, USA

ARTICLE INFO

Article history:
Received 20 December 2007
Available online 17 June 2009

JEL classification:
G24

Keywords:
Venture capital
Corporate venture capital
Strategic investing
Financial contracting
Product market relationships

ABSTRACT

We analyze financial contracting in start-ups backed by corporate venture capitalists (CVCs). CVCs' strategic goals can economically hurt or benefit the start-ups, depending on product market relationships between start-ups and CVC parents. Empirically, start-ups receive funding from both complementary and competitive CVC parents. However, start-up insiders commonly limit the influence of competitive CVCs, awarding them lower board power, while retaining higher board representation for themselves. Second, lead CVCs receive lower board representation, indicating heightened concerns about their greater influence in start-ups' early stages. Finally, start-ups extract higher valuations from competitive CVCs, reflecting greater moral hazard problems. Overall, CVC strategic objectives affect their early inclusion in VC syndicates, their control rights and share pricing.

1. Introduction

Since the early 1990s, US corporations have invested billions of dollars in young entrepreneurial companies (start-ups). By the late 1990s, at the height of their investment activity, corporate venture capital (CVC) accounted for nearly 15% of total venture investment in the US economy. Given that CVCs' parent corporations are often active players in new technologies and products markets in which start-ups are positioned, they appear to be natural candidates to engage in venture investment activity. This is especially true, given that CVC parents can offer start-ups valuable production capacity,

* Corresponding author.
E-mail addresses: ronald.masulis@owen.vanderbilt.edu (R.W. Masulis), raj_nahata@baruch.cuny.edu (R. Nahata).

1042-9573/$ - see front matter
doi:10.1016/j.jfi.2009.06.001

technical expertise, strategic alliances and customer–supplier relationships, in addition to venture capital funding. Since many start-up companies innovate in existing markets, established firms in these markets can be particularly keen to invest in start-ups. Gompers and Lerner (2000a), Dushnitsky and Lenox (2006), and Yost and Devlin (1993) report that most value-creating CVCs invest in start-ups to realize strategic benefits. CVC pursuit of strategic objectives can often benefit start-up firms, but they can also adversely affect start-ups creating a conflict of interest between CVCs and other start-up shareholders. In this study, we empirically assess the importance of strategic relations between CVC parents and start-ups and how it affects CVC participation and contracting terms in VC syndicates.

Hellmann (2002) develops an insightful theoretical analysis of the competitive advantages and disadvantages start-ups face when accepting corporate venture capital funding. A central feature of his model is that a corporate investor's quest for strategic benefits can turn into a competitive disadvantage for start-ups when the wealth gains CVCs realize from their actions are misaligned with the economic benefits accruing to other start-up investors. Given that CVCs can hold important control rights, economically damaging decisions can be forced upon start-up firms. From this perspective, Hellmann examines conditions under which start-up entrepreneurs prefer strategically oriented CVCs and when they prefer traditional venture capital (TVC) investors. In addition to strategic objectives, CVCs differ from TVCs in several other important dimensions.

CVCs generally make later-stage venture investments and CVC managers have weaker performance incentives compared to TVC general partners. For example, in a related study, Hellmann et al. (2008) explore the strategic nature of bank-VC investments and provide evidence that their investment choices appear closely aligned with their strategic objectives and thus, they have fundamentally different incentives from TVCs. Strategically-motivated investors (banks, corporations, etc.) are endogenously less inclined to build value-added support capabilities that TVCs typically excel in, and this is highlighted by their typically later stage venture capital investments. Second, TVC general partners are primarily compensated through 'carried interest' which is typically 20 to 30% of the VC fund profits, while CVC managers seldom receive similar compensation (Dushnitsky and Shapira, 2008). Both of these differences are likely to reduce the value-added support and quality of effort provided to start-ups by CVC managers. The lower compensation received by strategic VCs is also likely to diminish their risk taking incentives. Cumming (2006), for instance, notes that compared to traditional VCs, corporate VCs typically write contracts focused more on downside protection than upside potential.

Hellmann's (2002) analysis raises a number of interesting economic questions. How strong are start-up entrepreneur preferences toward VC investor types, and when will a start-up accept funding from strategic CVC investors? More importantly, is the allocation of shares and control rights among VC syndicate members consistent with concerns about unwanted interference by strategic CVCs toward start-up operating decisions? Are start-up control rights and shareholdings allocated in ways that motivate all stakeholders, including CVCs, TVCs and entrepreneurs, to provide strong financial, technical and managerial support to these ventures? These are issues that VCs often grapple with when deciding whether to involve strategic CVCs, based on our conversations with VCs. Finally, do the start-up share prices paid by strategic investors depend on the strategic nature of the CVC parent–start-up relation?

The challenge to testing the Hellmann (2002) predictions is the lack of data on CVC contracts. By focusing on CVC-backed IPOs where public disclosure is required, we are able to obtain detailed information about these start-up firm relationships with CVCs, allowing us to empirically analyze the nature of a CVC's strategic objectives and then investigate how they affect CVC participation in venture syndicates, the allocation of start-up shares and control rights among entrepreneurs and various classes of venture investors, and the prices paid by CVCs for start-up shares. From this investigation, we are able to test a number of predictions derived from Hellmann's theoretical analysis. The downside of using this data is the constraint of only studying CVC-backed IPOs, rather than all CVC-backed companies, which limits the scope of our conclusions. We investigate the representativeness of our sample in greater detail in Section 3.

To preview our results, we find that start-ups receive funding from both complementary and competitive CVC investors. However, founder entrepreneurs appear to be wary of CVC investors when their parents are potential competitors of these start-up firms, since even modest venture investments