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The relationship between governance structure and risk management approaches in Japanese venture capital firms

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Abstract

This paper attempts to understand what drives Japanese venture capital (JVC) fund managers to select either active managerial monitoring or portfolio diversification to manage their firms' investment risks [J. Bus. Venturing 4 (1989) 231]. Unlike U.S. venture capitalists that use active managerial monitoring to gain private information in order to maximize returns [J. Finance 50 (1995) 301], JVCs have traditionally used portfolio diversification to attenuate investment risks [Hamada, Y., 2001. Nihon no Bencha Kyapitaru no Genkyo (Current State of Japanese Venture Capital), Nihon Bencha Gakkai VC Seminar, May 7]. We found that performance pay is positively related to active monitoring and that management ownership is positively related to active monitoring and negatively related to portfolio diversification. The managerial implication of our study is that venture capitalists should be as concerned about the structure of their incentive systems for their fund managers as they are for their investee-firm entrepreneurs. Agency theory says that contingent compensation is a self-governing mechanism for individual effort that is difficult to measure and verify. When properly applied, equity ownership and performance-based pay can have powerful influencing effects on the strategic choices of managers.

Keywords: Risk management approach; Venture capital; Portfolio diversification

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1. Executive summary

This paper looks at the agency contract that exists between venture capital (VC) firms and their managers. We model the factors that drive Japanese venture capital (JVC) fund managers to select either direct managerial monitoring or portfolio diversification to manage their firms' investment risks (Gorman and Sahlman, 1989). Unlike U.S. venture capitalists that use direct monitoring to gain private information in order to maximize returns, JVCs have traditionally used portfolio diversification to manage investment risks. However, in recent years JVCs have used a mix of different strategies, including direct managerial monitoring. This change in industry practice provides an opportunity to test the applicability of agency theory in the JVC industry.

We theorize that the corporate affiliation of a JVC, compensation structure for its investment managers, and managerial stock ownership will predict whether an active (hands-on monitoring) or passive (portfolio diversification) risk management approach is chosen by the JVC fund manager. We did not find any relationship between the corporate affiliation and risk management approach. However, we found that compensation schemes and management ownership strongly affect a JVC's choice of risk management approach. Specifically, we found that performance pay is positively related to direct monitoring and that management ownership is positively related to direct monitoring and is negatively related to portfolio diversification.

The central roles played by compensation schemes and management ownership are congruent with the extant literature in agency theory. In fact, the results suggest that standard agency theoretic formulations may be generalized to the special case of Japanese venture capitalists, even though they are structured quite differently from their U.S. counterparts. Our results also suggest that direct monitoring is a multidimensional activity composed of direct intervention, as well as boardroom governance, as both were highly correlated to the latent governance construct. In this respect, JVCs seem to behave much like their U.S. counterparts.

The managerial implication of our study is that venture capitalists should be as concerned about the structure of their incentive systems for their fund managers as they are for their investee-firm entrepreneurs. Agency theory says that contingent compensation is a self-governing mechanism for individual effort that is difficult to measure and verify. However, such schemes must be sensitive to the organizational context in which they are applied. Our study shows that when the organizational culture puts a premium on distributive justice, as with many large Japanese corporations, some forms of contingent compensation such as equity ownership may not be easy to implement. On the other hand, when properly applied, equity ownership and performance-based pay can have powerful influencing effects on the strategic choices of managers.

That said, we cannot ignore the fact that the ultimate objective of VC investing by large Japanese corporations, indeed even the venturing arm of many U.S. corporations such as Intel, is not always the maximization of investment returns, but other strategic objectives such as the access to leading edge technologies or future business opportunities related to the parent's core businesses. In addition, because a large corporation has to deal with a diverse set