Full text available at: http://dx.doi.org/10.1561/0300000040

Venture Capital Investors and Portfolio Firms

Full text available at: http://dx.doi.org/10.1561/0300000040

Venture Capital Investors and Portfolio Firms

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Foundations and Trends® in Entrepreneurship

Published, sold and distributed by:
now Publishers Inc.
PO Box 1024
Hanover, MA 02339
USA
Tel. +1-781-985-4510
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The preferred citation for this publication is S. Manigart and M. Wright, Venture Capital Investors and Portfolio Firms, Foundations and Trends® in Entrepreneurship, vol 9, nos 4–5, pp 365–570, 2013.

ISBN: 978-1-60198-650-4
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Foundations and Trends® in Entrepreneurship, 2013, Volume 9, 6 issues. ISSN paper version 1551-3114. ISSN online version 1551-3122. Also available as a combined paper and online subscription.

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Foundations and Trends® in
Entrepreneurship
Vol. 9, Nos. 4–5 (2013) 365–570
© 2013 S. Manigart and M. Wright
DOI: 10.1561/0300000040

Venture Capital Investors and Portfolio Firms

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Abstract

The principal goal of this monograph is to provide an overview of relevant aspects and research findings pertaining to the period after the venture capital firm (also known as venture capitalist or VC) has made the decision to invest in a particular portfolio company (or entrepreneur). Drawing principally upon refereed journal papers in entrepreneurship, finance, and management, our review is divided into six principal areas: (1) what venture capital firms do, (2) the impact of VCs on portfolio firms and other stakeholders, (3) the role of syndication, (4) the nature and timing of exit from VC investment, (5) the role of VCs in portfolio companies that undergo an initial public offering (IPO), and (6) the returns from investing in VC. The monograph concludes with a detailed outline of an agenda for further research. We provide a summary of the main papers in this literature in a set of tables in which we identify the authors, publication date, the journal, the main research question, the theoretical perspective, data, and the principal findings.

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1

Introduction

It is well documented that venture capital is a special form of financing for an entrepreneurial venture, in that the venture capital firm is an active financial intermediary. This is in sharp contrast with most financial intermediaries such as banks, institutional, or stock market investors that assume a more passive role. Once the stock market investors invest in a company, they may monitor the performance of the company periodically but they seldom interfere with the decision making. In order to overcome the huge business and financial risks and the potential agency problems associated with investing in young, growth-oriented ventures (often without valuable assets but with a lot of intangible investments), venture capital firms specialize in selecting the most promising ventures and in being involved in the ventures once they have made the investment. The principal theme of this monograph is to provide an overview of relevant aspects and research findings pertaining to the period *after* the venture capital firm (or venture capitalist or VC) has made the decision to invest in a particular portfolio company (or entrepreneur).

The early papers on venture capital, venture capital investors, and the venture capital process started from the observation that venture

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capital cannot be considered as merely another category of financial intermediaries, which limit their activities to deciding on buying or selling shares, or on providing loans (Timmons and Bygrave, 1986). Given the high levels of information asymmetries and agency risk and given the low levels of collateral in the ventures which are the target of venture capital investors, venture capital investors are specialized in screening and valuing their investment targets, writing complex contracts, monitoring and adding value to their portfolio companies, and finally exiting their investments (Gorman and Sahlman, 1990). Importantly, venture capital investments often involve multi-stage decisions as investors typically provide funds to entrepreneurial investors over several investment rounds (Wright and Robbie, 1998).

1.1 Focus of the Monograph

We limit our overview of venture capital research to a narrow definition of venture capital and to specific topics. A broad definition of venture capital includes the range of entrepreneurial finance from early-stage "classic" venture capital through to later stage private equity for management buyouts and buy-ins. There has recently been an explosion of interest in private equity-backed buyouts, although the origins of this literature stretch back to the early 1980s. This literature has been the subject of detailed reviews elsewhere and is largely excluded here unless samples also include VC investments or raise general issues for the VC literature (for detailed reviews see for example Gilligan and Wright, 2010; Wright et al., 2009). Similarly, business angels which provide funding for entrepreneurial ventures as informal investors are also excluded. This extensive literature has also been reviewed elsewhere (for example Kelly, 2007). This book is therefore limited to the narrow definition of VC as investor in young growth-oriented companies.

We chose to focus on the later phases of the VC investment process, hence emphasizing monitoring, value-adding, and exiting activities. We thus take VC investment decisions and contracts as given (for introductions to this literature, see Wright et al., 2003). Further, we review the literature on the outcome of venture capital investment activities. What does venture capital contribute to portfolio companies, to entrepreneurs

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and to economic (regional) development at large? How does the syndication of venture capital investments impact the relationships between VCs and portfolio companies? Does the financial return generated through these activities benefit investors in venture capital funds?

Even with this limited focus, the number of papers reviewed is substantial reflecting the explosion of the literature on post-investment venture capital over the past four decades (Figure 1.1). Of the over 240 venture capital papers reviewed here, only one was published in the 1970s. From 14 published in the 1980s, the number of papers published trebled in the 1990s and more than trebled again in the first decade of the 2000s. The literature reviewed here represents only about 16% of all papers on venture capital referenced in the Web of Science during this time period (Figure 1.2). The annual number of papers on venture capital has exploded in the last 15 years, to reach between 140 and 185 papers per year in the last five years. Interestingly, the growth in the number of papers on venture capital mirrors the importance of the venture capital industry, with a peak in publications following venture capital boom periods.

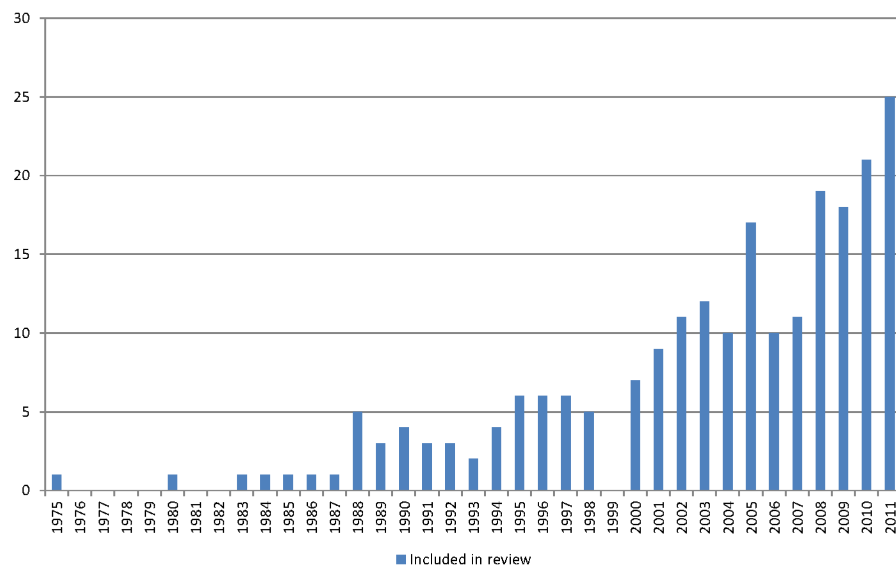

Fig. 1.1 Number of papers reviewed, per publication year.

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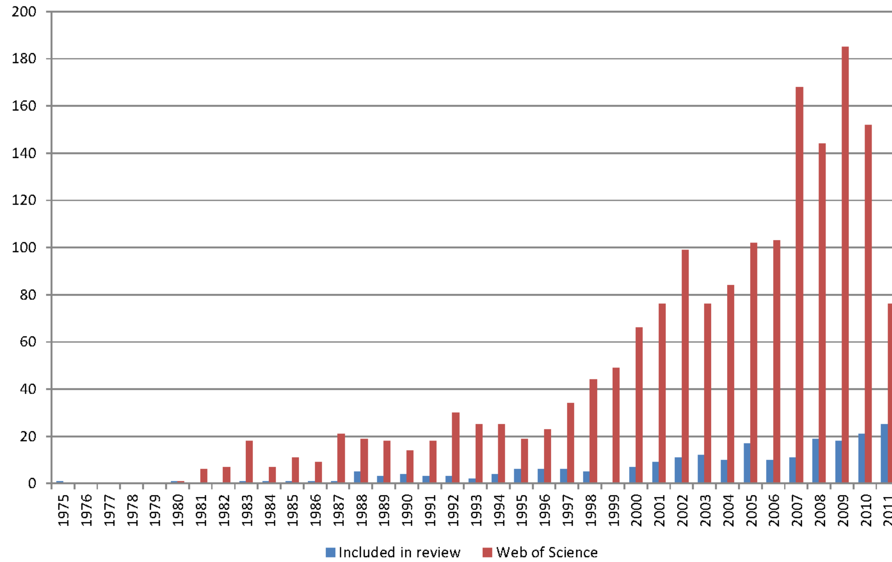

Fig. 1.2 Total number of venture capital papers published per year.
Source: Web of Science.

Our choice to focus on a limited number of topics implies that this monograph will not do justice to numerous excellent papers and important insights generated on topics like venture capital selection and contracting, but also on the insight that the venture capital industry is not uniform (Timmons and Bygrave, 1986). The dominant type of venture capital firm is an independent partnership managing one or more limited life, closed-end investment funds. VC firms act as general partners in managing the fund on behalf of the limited partners (e.g., pension funds). Other types of venture capital firms are often captive firms. Captive firms obtain their funding from a parent financial institution. Corporate VC firms are parts of trading corporations. Semi-captive VC firms obtain their finance partly from their parent and partly by raising closed end funds. Public sector funds obtain their finance mainly from government agencies. Some venture capital firms are also listed companies. Different goals, organizational forms, incentive schemes, and covenants mean that different types of venture capital firms develop specific investment strategies, activities, and outcomes (Cumming and Johan, 2009; Heughebaert and Manigart, 2012). These different types

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of venture capital firms may be assessed on different criteria by their investors, which influences the type of deal selected, the time horizon of the investment, and the exit route (Chiplin et al., 1997; Mayer et al., 2005). This monograph focuses mainly on independent venture capital firms and captive investors with commercial objectives, hence largely ignoring the insights generated on, for example, public or university-related venture capital.

Further, recent studies have begun to focus on the relationship between venture capital and the institutional context, explaining variations in venture capital activity and involvement with portfolio companies worldwide based upon differences in the legal and social context (Cumming and Knill, 2012; Cumming et al., 2009; Cumming and Zambelli, 2010, 2012; Meuleman and Wright, 2011). In what follows, we highlight the differential effects of institutional context as appropriate.

We draw principally upon refereed journal papers in entrepreneurship, finance, and management. We therefore omit VC literature relating to other disciplines, notably law. Within the disciplines covered by our overview, we did not restrict our search only to a limited number of "top journals" primarily because of the subjectivity of deciding what constituted a top journal across disciplines. We incorporate theoretical and empirical papers and among empirical papers we include both qualitative and quantitative papers.

We also restrict our review principally to papers published or forthcoming in refereed academic journals and thus largely omit working papers and books or book chapters, as well as industry reports. In the chapters that follow, our review is divided into six principal areas: what venture capital firms do; the impact of VCs on portfolio firms and other stakeholders; the role of syndication; the nature and timing of exit from VC investments; the role of VCs in portfolio companies that undergo an initial public offering (IPO); and the returns from investing in VC. We conclude with a detailed outline of an agenda for further research in this area. To aid the reader wishing to pursue particular papers in more detail, we provide a summary of the main papers in this literature in a set of tables where we identify authors and date, journal, main research question, theoretical perspective, data, and principal findings.

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