EQUITY TRAPS: NEAR EQUAL DISTRIBUTION OF CASH FLOW INCENTIVES AMONG INVESTORS IN VENTURE CAPITAL SYNDICATES AND THE PERFORMANCE OF START-UP AND VC FUNDS (SUMMARY)

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SUMMARY

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Introduction

The most common method of allocation is equal distribution of resources, irrespective of the need or ability of the individuals in a group (Camerer and Thaler, 1995). Psychologists suggest that equal distribution requires the least cognitive effort and hence it is the starting point for allocation of resources in a group. Economists, on the other hand, point out that any distribution that ignores the relative ability of the actors is sub-optimal. In this project I study the relationship between the near equal and unequal distribution of incentives among investors in a Venture Capital (VC) syndicate. In nearly 13,000 rounds of syndicated deals from 1980 to 2004, I find that start-ups that receive more unequal investments are more likely to have a subsequent round of funding or an IPO or an M & A event.

Theory and Hypotheses

The models I draw on for the empirical analysis are the agency and moral hazard model explaining credit and financial intermediation (Holmstrom and Tirole, 1997). Wherein a large stake in a project by one informed investor leads to optimal allocation of due diligence and monitoring effort. Survey work on venture capital round distribution and provision of effort is also consistent with the arguments I make (De Clercq, Sapienza, Zaheer, 2007).

Hypothesis: There is a positive relationship between unequal distribution of round amount among VC firms in a round of financing and the performance of the portfolio company.

Method

The data for this analysis is from Thomson Financial’s Venture Economics database. Venture Economics covers nearly 90% of all venture capital transactions in the US (Gompers and Lerner, 2001). Since performance data is not publicly disclosed the most common proxy for the performance of a VC firm is the proportion of investments that achieved a successful IPO or an M & A exit (Hochberg, Ljungqvist, Lu, 2007). I use an instrument variable approach to first estimate the endogenous variable of round distribution and then estimate the impact of round distribution on performance.

Implications for theory and practice

I find that the incentive distribution to the lead financial intermediary matters more when mentoring and monitoring needs of the start-up are the greatest. The results of this study suggest that VC partners share the investment based on the mentoring and monitoring needs of the start-up.

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