DOES SECURITY CHOICE MATTER IN VENTURE CAPITAL? THE CASE OF VENTURE DEBT (SUMMARY)

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Principal Topic

This paper explores the relationship between debt in the entrepreneurial capital structure and outcomes. The focus of the analysis is documenting and explaining a puzzling fact: in contrast to public firms where debt is considered a positive signal, venture capital (VC) debt is associated with poorer future firm performance. Source of debt also impacts predicts differences in firm performance.

Method

In a panel entrepreneurial firm, we ask whether debt events have any within-firm predictive power for changes in valuation. A cross-sectional analysis complements this estimation by asking whether past debt events correlation with final entrepreneurial success (e.g. initial public offering or failure). The empirical results motivate a simple theoretical model motivated by the Hellmann (2006) model of convertible securities. We introduce a shock to the entrepreneurial firm prospects that introduces a role for debt as an endogenous response to unobserved changes at the firm. Finally, the theory suggests additional implications about the source of the debt to the entrepreneurial firm, which we test using the same empirical methodology.

Results and Implications

Entrepreneurial firms that raise debt have lower valuations post-debt and lower probability of IPO or acquisition in the future. Debt does not seem to be driving the differences. Debt lent by investors with existing equity stakes predicts relatively worse within-firm and final outcomes. These empirical regularities directly follow from the theoretical model and provide support for the unique role of debt in venture capital. Further, we show that the proposed incentive mechanism – rather than a response to increased bankruptcy probabilities – is supported in the data. The near-absence of information asymmetry between the VC and entrepreneur coupled with the importance of the latter’s effort for success creates the contrasting results with the seminal capital structure theories. The results also highlight a new role debt in the high-growth entrepreneurial firm lifecycle.

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