RISK SHIFTING IN HYBRID VENTURE CAPITAL FUNDS (SUMMARY)

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RISK SHIFTING IN HYBRID VENTURE CAPITAL FUNDS

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Principal Topic

Government fund-of-funds programs aim to increase the availability of venture capital (VC) funds to early-stage companies by using private VC firms as a channel to allocate public funds (Wilson & Silva, 2013). To achieve this goal, policy makers have the ability to use profit distribution and compensation structures that improve the expected returns in market failure areas in order to attract private sector investors and professional managers to participate in early-stage funds (Jääskeläinen et al., 2007). However, these enhanced compensation mechanisms may create adverse incentives for VC firms that manage overlapping non-government sponsored VC funds. Instead of increasing the overall risk exposure of the combined funds, the altered compensation mechanism could incentivize VC firms to shift the risky investments, which they would make even in the absence of the hybrid VC fund, to the hybrid VC fund. As a result, the VC investor could improve his risk-return profile at the expense of the government fund-of-funds investor. In this study, we aim to contribute to the literature on government fund-of-funds programs (Buzzacchi et al., 2013 & 2015; Brander et al.; 2015; Munari & Toschi, 2015; Colombo et al., 2016) by focusing on the risk shifting behavior of different types of VC firms that manage hybrid VC funds and overlapping non-government sponsored VC funds.

Method

After having identified 1,207 VC funds, managed by 697 private VC firms, that received an investment from at least one of the 34 national or regional European government fund-of-funds programs, we compare their investment behavior with that of the non-government sponsored VC funds managed by the same VC firms by analyzing the risk profiles of 25,411 portfolio companies.

Results and Implications

This study will contribute to our understanding of the impact of government fund-of-funds programs by examining the emergence of possible agency problems between government fund-of-funds investors and private VC firms. Our findings will allow governments to better design their fund-of-funds programs.

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