AFTER DUE DILIGENCE: HOW VENTURE CAPITALISTS’ EVOLVING RISK PERCEPTIONS INFLUENCE THEIR EXIT (SUMMARY)

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SUMMARY

AFTER DUE DILIGENCE: HOW VENTURE CAPITALISTS’ EVOLVING RISK PERCEPTIONS INFLUENCE THEIR EXIT

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Principal Topic

This research draws from the behavioral theory of the firm and behavioral decision theory to analyze how venture capitalists’ evolving valuations, risk assessments and cognition influence discounted exit from portfolio companies.

Method

The research sample is 51 companies in a venture capital firm’s portfolio using data from 1/01/02 through 09/30/05. The data sources are the quarterly reports to limited partners and quarterly internal risk assessments. The data were analyzed using logistic regression. The dependent variable is the likelihood of discounted exit (proceeds less the total investment) at \( t_{n+1} \). The independent variables are:

- Prior investment multiple (H1 - prior performance): The ratio of the fair market value of the portfolio company divided by the total investment cost at \( t_{n-1} \).
- Assessed risk (H2 - risk perception): The assessed risk level at \( t_n \).
- Prior high-risk assessments (H3 - status quo bias): The number of “high” risk assessment scores in the four quarters prior to \( t_n \).
- Duration of investment (H4a - escalation of commitment): The number of quarters from the initial investment at \( t_0 \) to \( t_n \).
- Total investment (H4b - escalation of commitment): The total investment in the portfolio company as of \( t_n \).
- Risk item variance (H5 - confirmation bias): The variance of individual risk items in the overall assessment at \( t_n \).

Control variables: business age and portfolio company industry.

Results and Implications

Only the prior investment multiple had a significant relationship to subsequent discounted exit; prior risk assessment and the cognitive proxies had no significant effect. However, supplementary analysis showed that discounted exit and persistent company subsamples are different throughout their tenures in the portfolio. As early as 18 months after the initial investment, the discounted exit companies had fallen behind the persistent companies, in terms of both investment multiple and risk. Furthermore, the discounted exit companies never improved relative to the companies that persist. One practical implication is that venture capitalists should reconsider their commitments to portfolio companies whose valuations are below the median for their cohort, or whose risk levels are above the cohort median.

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