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FORECAST BIAS OF ENTREPRENEURS IN VENTURE CAPITAL-BACKED COMPANIES (SUMMARY)

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SUMMARY

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Principal Topic

We aim to add to the entrepreneurial forecasting literature by examining forecast rationality in the context of venture capital-backed companies. In this setting, entrepreneurs’ forecasts of future venture performance may not only be influenced by cognitive biases such as overconfidence or optimism (Cassar, 2010), but also by strategic incentives of entrepreneurs to present themselves more favorably to their venture capitalists, trying to ensure continued support and funding at better terms from their investors (Smith and Smith, 2002). Therefore, we argue that initial forecasts of entrepreneurs in venture capital-backed companies are likely to suffer from overestimation. Further, we will examine a previously unaddressed aspect of forecasting bias in entrepreneurial settings, namely their evolution. Venture capitalists are known to monitor their portfolio companies and hold them accountable when expectations are not met (Parhankangas and Landström, 2006). Combined with an increased tendency to internalize venture capitalists’ concerns, resulting in reduced overconfidence (Forbes, 2005), one would expect entrepreneurs’ forecasting biases to shrink as investment duration increases.

Method

We use a longitudinal database containing data on 184 participations of a large Benelux venture capital firm. These result in 434 forecasting errors, calculated as the difference between forecasted and realized profits (and revenues), divided by the sum of these two (as in Cassar, 2010). These data are unique in that previous research has either relied on data solely provided for research objectives (Cassar, 2010; Cassar and Gibson, 2007) or on publicly released forecasts by more established companies (Citron et al., 2009). By relying on data that are confidential in nature, we exclude potential problems due to market manipulation, venture capital signaling and reputation effects (Citron et al., 2009), while simultaneously being able to use actual, real-life numbers as provided to the venture capitalist.

Results and Implications

We show that entrepreneurs of venture capital-backed companies are overly optimistic in their revenue and profit prognoses, but that these overoptimistic biases decrease over time. This may be explained by entrepreneurial learning and venture capitalists’ monitoring. As such, this study contributes to our understanding of the dynamic nature of forecasting errors in entrepreneurial settings.

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