DEMYSTIFYING THE VC BUSINESS MODEL (SUMMARY)

Maximilian Schmidt
Technische Universität München, maximilian.schmidt@wi.tum.de

Reiner Braun
Universität Erlangen-Nürnberg

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SUMMARY

DEMYSTIFYING THE VC BUSINESS MODEL

Maximilian Schmidt, Technische Universität München, Germany
Reiner Braun, Universität Erlangen-Nürnberg, Germany

Principal Topic

When professional investors such as pension funds, fund-of-funds etc. are asked by VC firms to invest into their funds, they face a problem of adverse selection: VC firms’ skills to generate high returns are a hidden characteristic (Akerlof, 1970). Hence, VC firms provide them with information on the portfolio of current VC funds they manage. At that time current funds are often not older than 3-4 years and final performance of these funds is hard to predict. While previous literature has shown a conflict between the general partners of a VC fund and its investors (Gompers, 1996; Kandel, Leshchinskii & Yuklea, 2011), this study goes one step further. We aim at identifying certain investment and divestment patterns of the current VC fund until the time of raising a new fund, which might convey reliable information to predict final fund performance. Thereby, we help investors to distinguish the ‘good’ from the ‘bad’, which is particularly important given the headwind the VC industry is currently facing due to its underperformance in comparison to other asset classes (Harris, Jenkinson & Kaplan, 2012).

Method

This study uses a novel, proprietary data set offering detailed information on 406 VC funds which invested in 11,395 deals between 1981 and 2008. Most importantly, this data set contains deal level monthly cash flows allowing us to compute exact measures of deal and fund performance. We apply multivariate regressions to show window dressing behavior and unravel observable signals of investing and divesting behavior of top performing funds.

Results and Implications

We are able to show that VC funds go through distinctive fund stages that have a strong impact on VC funds’ investment and divestment decisions as well as performance. Most importantly, we are able to show that VC firm skills, resulting in top performance at fund maturity, are, at least to some extent, observable early on in a fund’s lifetime, when the next fund is raised: top funds are able to signal substantial higher ratios of distributed to invested capital (i.e. shorter time to breakeven) prior to closing a new fund. These results will help professional investors in venture capital to identify highly skilled VC firms by mitigating the issue of adverse selection.

CONTACT: Maximilian Schmidt; maximilian.schmidt@wi.tum.de; (T): +49-89-289-25102; (F): +49-89-289-25188, TUM School of Management, Arcisstr. 21, 80333 München, Germany.