DETERMINANTS OF THE FLOWS OF VENTURE CAPITAL IN THE USA (SUMMARY)

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Principal Topic

We develop econometric models for the annual flows of money into and out of venture capital funds in the USA. We examine the interconnectedness of the following factors believed to affect the flows: limited partners’ annual internal rate of return, the emergence of new industries, government policies, and public stock markets.

Method

We tested the following hypotheses:

\[
\text{Venture capital commitments} = f(\text{Limited partners' annual IRR, Stock market indices, Public policy changes})
\]

\[
\text{Limited partners' Annual IRR} = f(\text{Number of IPOs, Amount raised with IPOs, Number of acquisitions/mergers, Value of acquisitions/mergers})
\]

\[
\text{Venture capital investments} = f(\text{Limited partners' commitments, growth rate of emerging new industries})
\]

Results and Implications

Results: the annual amount of new commitments correlates with the annual IRR in the previous year (p<0.000001); the annual IRR correlates with the annual number of IPOs (p<0.01); and the annual amount of new investments correlates with the amount of new commitments in the previous year. The Internet/Web was the only emerging industry that was significant (p<0.05). No other variables were significant at the 0.05 level.

Based on our results, we conclude that financial returns govern the flows of venture capital and that returns are determined by the number of IPOs. Neither the number of acquisitions nor their total value correlated with the rate of return; indeed, there was a glimpse that the number of acquisitions was negatively correlated with the returns (p<0.1). We think that it is because IPOs are on average much more lucrative than acquisitions and set the valuation of acquisitions. When the IPO window is closed or barely ajar, valuations are lower and fewer companies are harvested via IPOs and more via acquisitions. The only emerging industry that had a significant effect on the flows was the Internet/Web, which was no surprise as the returns during that era were astronomical. We found no relationship between changes in the capital gains tax and the flows. Again, it was not surprising as the percentage of commitments coming from participants affected by the capital gains tax is relatively small. Our findings imply that the most important policy to foster robust flows of venture capital is one that ensures healthy stock markets for IPOs.

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