A SIGNALING THEORY OF ENTREPRENEURIAL VENTURE’S VALUATION: EVIDENCE FROM EARLY TERMINATION OF VENTURE CAPITAL INVESTMENT (SUMMARY)

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A SIGNALING THEORY OF ENTREPRENEURIAL VENTURE’S VALUATION: EVIDENCE FROM EARLY TERMINATION OF VENTURE CAPITAL INVESTMENT

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Principal Topic
Entrepreneurs seek venture capital support not only for financial support; but also since the backing of VCs is a quality signal to the market. In this paper, we aim to draw from signaling theory to shed light into how the early termination of investment in an entrepreneurial venture by an existing investor conveys a negative signal, resulting in a “side-effect”. We argue the side effect is a consequence of the presence of information asymmetry in entrepreneurial financing. Information asymmetry is a prevalent feature of entrepreneurial financing since entrepreneurial ventures have a short track record of performance and lack legitimacy. We find that the decision of potential investors is adversely affected if an investor gives up funding the subsequent rounds of financing, furthering adverse selection problems.

Method
We construct a sample of 5,016 round of VC investment in 1,728 entrepreneurial ventures that received more than one round of investment. We apply the Heckman two-stage framework to control for the endogeneity of VC early termination and examine the impact of VC early termination on the financial terms and quality of potential investors in the next round of financing.

Results and Implications
By controlling for quality of entrepreneurial ventures we find that early termination is associated with lower valuation in subsequent round of financing and also reduce the attractiveness of the venture by attracting lower quality potential VCs in its follow-on round of investment.

Our goal is two-fold in this paper; first, we reveal the manifest of negative signal in the subsequent valuation of the venture, which has experienced early termination of investment. We report results in entrepreneurial finance, consistent with Akerlof’s prediction (1970). Akerlof (1970) uses the markets for used cars to demonstrate a discount in price is followed by exacerbated levels of information asymmetry. Second, we seek to examine the view held by economists that accreditation of party that originates the signal may moderate the (negative) perception of the signal, ceteris paribus. We find that the prominence of VC leaving the venture and stage specialization of VC are moderating the negative signal of early termination on venture’s valuation to different degrees.

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