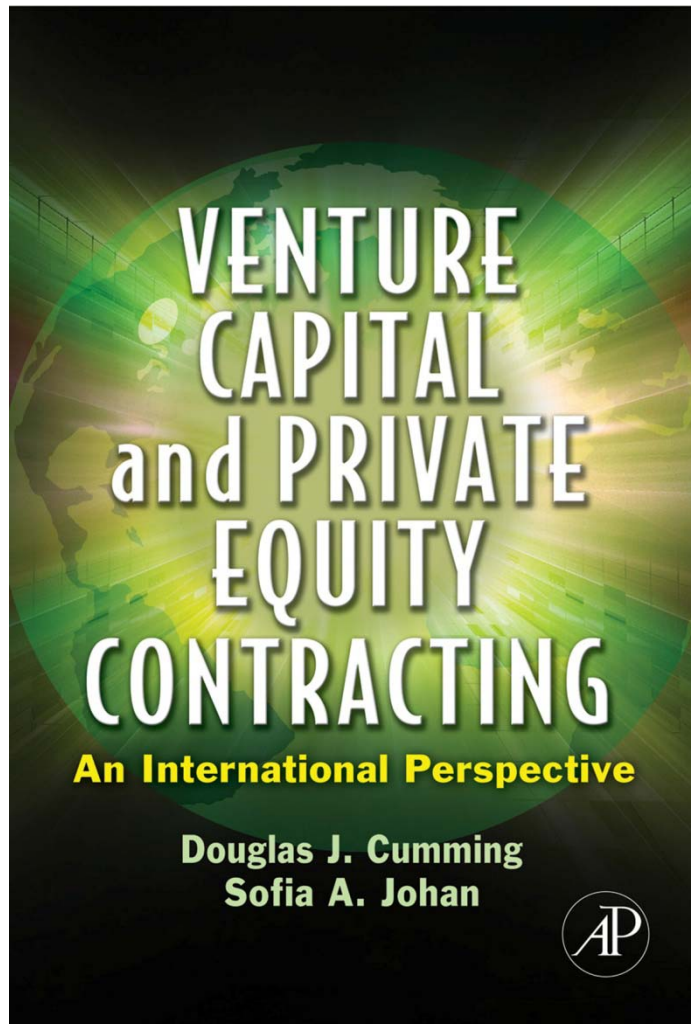


# Venture Capital Contracting and Investment Performance



Elsevier Science Academic Press, 2009 (770 pages)

Evidence on venture capital contracts from Europe

Relationship between contracts and exits, returns

<http://www.venturecapitalprivateequitycontracting.com/>

# Financing Economic Development through IP Assets

- Outline
  - Venture Capital and Protecting IP Assets
  - Venture Capital Contracts
  - Venture Capital Exits
  - Venture Capital Returns

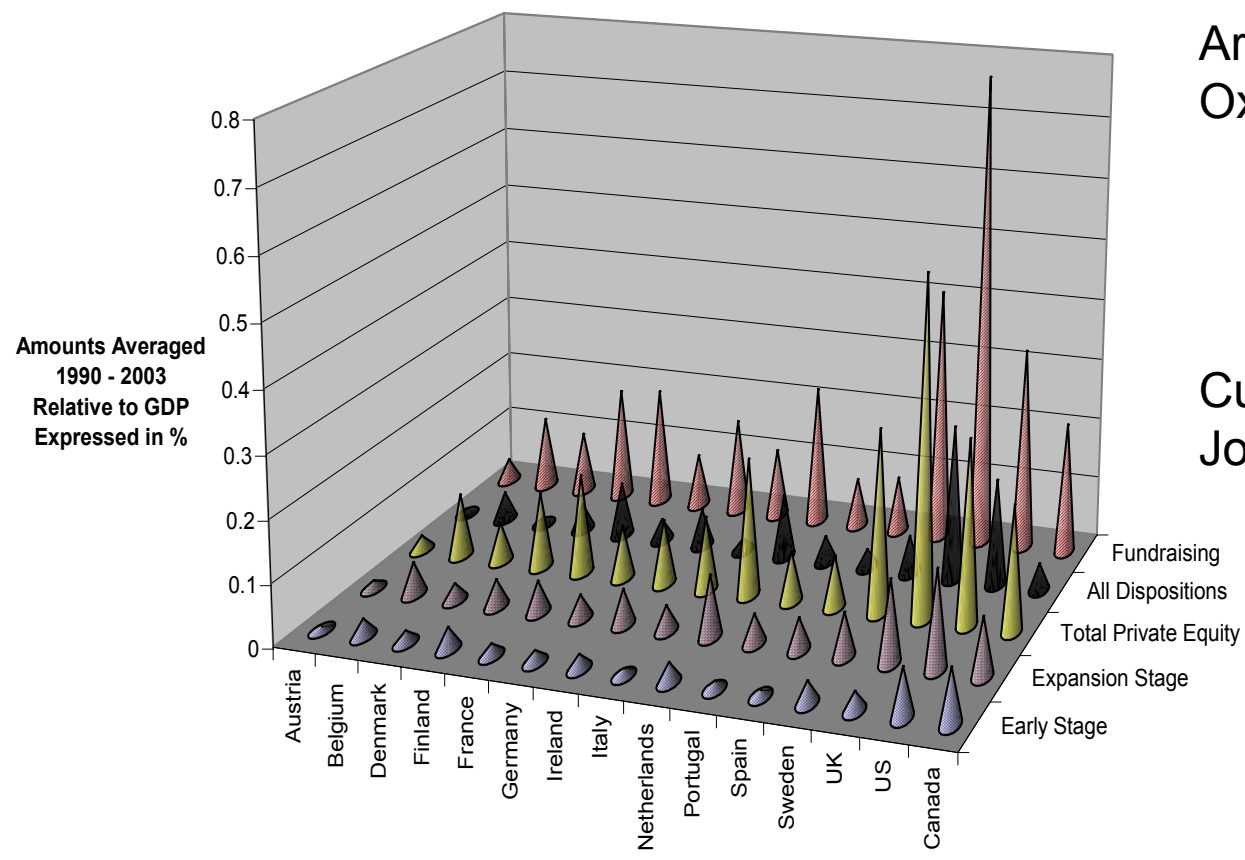
# Venture Capital and Protecting IP Assets

- Countries with stronger legal protection have stronger VC markets and more detailed VC contracts
  - IP Protection
  - Rule of Law
  - Contract Enforcement
  - Efficiency of the Judiciary
  - Shareholder Protection

# Comparison of European and North American VC

Figure 1.4. Size of Venture Capital and Private Equity Markets Across Countries

Source: Armour and Cumming (2006)



Armour and Cumming 2006

Oxford Economic Papers:

- Common Law vs Civil Law
- Bankruptcy Law
- EVCA Tax and Legal Index

Cumming and Zambelli 2009

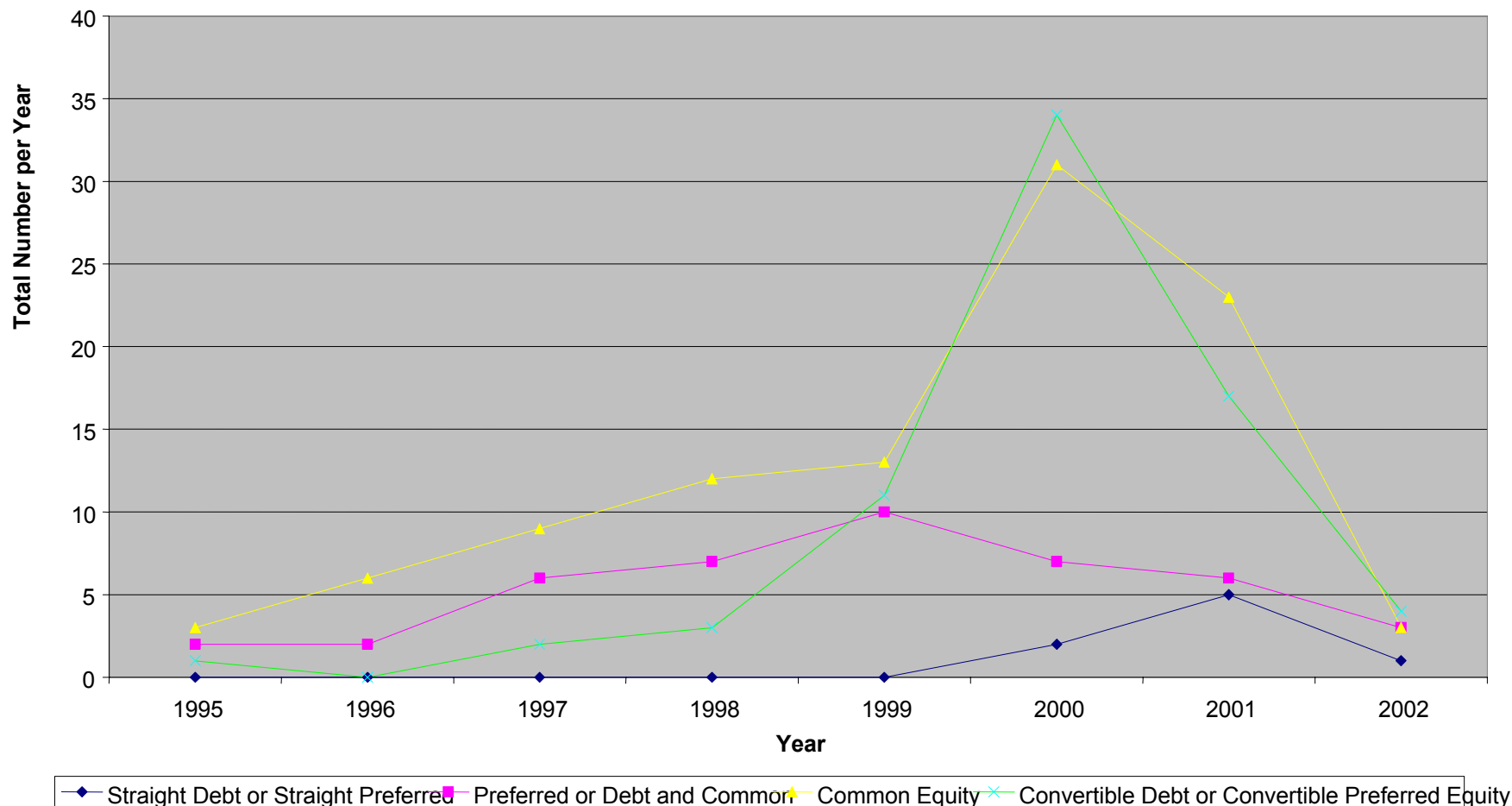
Journal of Banking & Finance  
 - Uncertain legal conditions in Italy

# VC Contracts: Cash Flow & Control Rights

- Security
  - Common, preferred, convertible preferred, etc
- Veto rights
  - Asset sales & purchases, changes in control, issuance of equity
- Control rights
  - Drag along, tag along, first refusal, replace CEO, redemption, demand registration, antidilution, etc

# VC Contracts in Europe (Cumming & Johan 2008 EER)

Figure 14.1. Securities Used by Year of Investment



# VC Contracts in Europe (Cumming & Johan 2008 EER)

- Convertible preferred equity and more detailed control rights in contracts for
  - preplanned acquisition exits
  - Captive investors (corporate VCs)
- Common equity and fewer contractual terms
  - More experienced entrepreneurs

# What is a “Venture Capital Exit” ?

- The means by which venture capitalists (VCs) dispose of their investments (recall introductory statistics lecture)
- Exit Types
  - » IPO
  - » Merger/Acquisition
  - » Secondary Sale
  - » Buyback
  - » Writeoff

# What Drives Choice of VC Exit?

1. Entrepreneurial firm characteristics
2. VC characteristics
3. Cash flow and control rights between VC and entrepreneur
4. Market conditions
5. Legality and institutional factors across countries

# 1. Entrepreneurial Firm Characteristics

- Size
  - Minimum listing standards for IPO
- Quality
  - Not possible to take bad companies public?!
  - Important to minimize information problems to max sale price (next slide)
- Industry
  - High Market/Book → high growth potential
- Location
- Transaction synergies with new owner(s)
  - Very important for acquisitions, & possibly IPOs

## 2. VC Characteristics

- LPs versus corporate
- & versus Government funds!
- Kliener Perkins versus “Fargo” VC Fund
- Fund Capital
- Connections with Investment Banks and/or Microsoft type companies

## 3. Control Rights

- Entrepreneurs have a non-pecuniary preference for IPOs
- Weak VC control rights and common equity → IPOs more likely?
- Strong VC control rights and convertible securities → acquisitions more likely?

## 4. Market conditions

- Significant factor in IPOs
  - 1999 – April 14, 2000
- Also a significant factor in write-offs!
  - Post April 14, 2000
  - Post August 2007

## 5. Legality / Institutional Factors

- Legal
  - Quality of shareholder rights
  - Corruption
  - Contract repudiation
  - Rule of Law
  - Efficiency of Judiciary
- Institutional
  - Size of country's stock market

# Cumming (2008 RFS): VC Contracts Affect Exits

- Control rights
  - Drag along, tag along, first refusal, replace CEO, redemption, demand registration, antidilution
  - Stronger probability of acquisition
  - Weaker probability of IPO and write-off
- Why? Entrepreneur nonpecuniary preference for remaining CEO

# Returns: Cumming and Walz (2009 JIBS)

- 39 countries, >5000 VC/PE investments
- Returns higher for
  - Stronger legal conditions, market conditions
  - Convertible preferred securities
  - Syndication (not co-investment)
  - VCs that do not have large portfolios / manager
- But: VCs overstate the value of unexited investments for additional fundraising!

# Venture Capital Cycle

Pension  
Plan  
Members  
(you and I)

**Institutional and  
Other Investors**

E.g., CALPERS  
California Public  
Pension Fund

Why care?  
Distorted asset  
allocations,  
less overall  
fundraising

→ Cumming & Johan  
2007 JBF

→ CD Howe Institute,  
AEI Sciences Po,  
Brookings,  
PWC,  
EVCA, NVCA, etc.  
They all care a lot!

\$

Returns

Reporting bias of  
unexited returns  
in annual reports?

→ Cumming & Walz  
2009 JIBS

**Venture Capital Funds**

\$

Returns (realized vs 'expected')

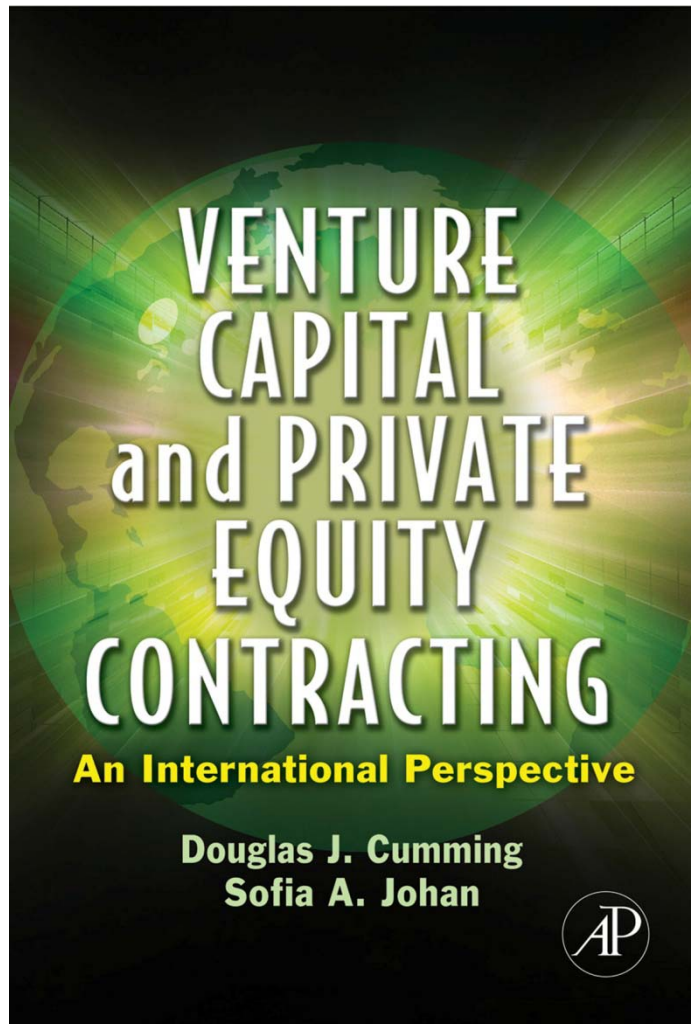
2-7 years before  
exit event (IPO,  
Acquisition, Write-off)

**Entrepreneurial Firms**

# Summary

- Legal conditions help VC markets
  - Larger markets
  - More certain contracts
  - Better exits
  - Better returns
  - Less bias in reporting unexited returns
- Effective contracts can help VC investment process and returns

# Empirical evidence available from Elsevier...!



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