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# **RISK MANAGEMENT AND VENTURE CAPITAL PRACTICE**

## **Introduction**

Risk is at the heart of every venture capital operation. It covers a multiple reality which is linked, on the one hand, to the technical and commercial characteristics of the project and to managerial considerations on the other.

Venture capitalism is a specific financing method. This method is based on intermediation, in which risk is grasped in its entirety. It differs from other proprietorial financing methods on account of the monitoring or the partnership implemented by the investor and senior management. Monitoring of this type, a true lever for the creation of value, is a way in which to limit the risk incurred.

Although the selection and evaluation methods for financed ventures have been the object of extensive research, the analysis of this monitoring has only recently attracted increasing numbers of researchers. Our analysis will concentrate on managerial risk and its consequences on the modus vivendi of financed participation.

## **I The situation of adverse selection**

Milgrom & Roberts (1997)<sup>1</sup> defines this as a « precontractual problem. The problem presents itself, on the one hand, when, in a transaction, one of the two parties holds private information regarding elements that are likely to affect the net profits that the other party could draw from the contract and, on the other hand, when only those that hold the private information that could considerably disadvantage the other party agree to counter». During the evaluation and selection phase, this can lead to poor estimations as regards the development project's capacity to achieve the expected value due to this lack of quality information. The problems of adverse selection depend principally on the stage of development and the sector to be financed.

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<sup>1</sup> Definition page 794.

Chan (1983) underlines the role of the venture capitalist through the reduction of the risk of adverse selection on the entrepreneurial financing market. In situations of adverse selection, only inferior quality financing projects would be proposed to Venture Capitalist. By questioning informational efficiency on the venture capital market, this author justifies the role of the Venture Capitalist as a producer of «expert<sup>2</sup>» information.

Amit, Glosten and Muller (1990) set out an agency model in which the venture capitalist is unsure of the contractor's capabilities when the latter sets out his financing requirements. The decision-making process of the investor defines the required levels of competence and predicts the type of contractor that the Venture Capitalist can expect to have a relationship of cooperation with.

The risk solution linked to situations of adverse selection varies according the level of involvement of the investor which has a bearing on the design of the implemented contract. Below, we look at the role played by the venture capitalist within the board of directors.

### **11 The involvement of the investor**

The level of involvement of the investor is illustrated by the type of governance implemented. In the profession, we differentiate hands off financing which involves negligible levels of involvement, from hands on financing which is marked by regular and involved monitoring. Numerous academic studies have attempted to explain this concept and its different managerial interpretations by the frequency of interaction between the venture capitalist and senior management of the venture. Mac Millan et al (1989), for example, identify three levels of involvement: low, moderate and high. Similarly, Elango et al (1995) propose three levels of involvement in financed ventures.

Generally speaking, the level of involvement regarding venture capital in a financed venture is linked to the participation financing policy defined by the investors (Mac Millan et al (1989), Beecroft (1994), Lerner (1995)). In monitoring participation, high involvement levels require the implementation of (human, technical...) resources within the Venture Capitalist in order to finance the costs linked to the regular monitoring of the venture.

Every working paper regarding the involvement of the investor sets out various factors by way of explanation:

- *The stage of development of the venture.* According to Gorman and Sahlman (1989), Sapienza and Gupta (1994), financing the first phases of the life cycle of a venture requires investors to be more heavily involved than in later phases. Conversely, Elango et al (1995) did not discover links between involvement levels and the stage of development of a financed venture.
- *The risk level.* Sapienza (1992), Sapienza et al (1994b), Ehrlich et al (1994) consider that the risk level serves to explain the level of involvement of the venture capitalist. These authors believe that the notion of risk can be read multi-dimensionally: business risk, agency risk... . Sapienza and Gupta

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<sup>2</sup> Ged & Lantz (1999).

(1994) show that relations between the venture capitalist and senior management are very frequent in situations when the objectives of these two players do not converge.

- *Experience in the management of the firm.* Rosenstein (1988) defines two methods of involvement after the investor has contributed financial resources : the venture capitalist changes the team and replaces it with more experienced management, or he collaborates with the team already in place. Involvement is therefore even greater when the firm's management lacks experience. (Sapienza and Gupta (1994))
- *The financial needs of the venture and the sums to be invested.* (Barry (1994)).
- *The experience of the venture capital entity.* Experience levels are based, on the one hand, on the business practice of the venture capitalist (selection of ventures to finance, evaluation) and, on the other, on specific knowledge (sectors, activities, ...). Sapienza et al (1995), (1996) have demonstrated that experienced venture capitalists specialising in the financing of specific sectors achieve greater value than others with less experience or without a specialised intervention policy. All of these elements bring about the existence of possible economies of scale in the Venture Capitalist monitoring.
- *The number and type of investors in the syndication operation implemented for financing the venture.* Lerner (1994) believes that syndication is a way in which to limit situations of adverse selection. By syndication, we mean sharing the financing amount between various different venture capitalists. This investment method can be applied at any stage of development of the venture<sup>3</sup>. This can subsequently be justified by the amount of the funds raised (Bygrave (1987)), the type and reputation of the Venture Capitalist, the organisation in charge of the participation policy. Syndication can achieve a better selection of investment projects and better control, principally through improved information sharing. Lockett and Wright (2001) provide a new theoretical perspective that incorporates the resource theory. Based upon a study carried out on British venture capitalists, these authors demonstrated that financial imperatives (one of these being the apportionment of risk) remain a principal justification for syndication, reinforcing the results obtained beforehand and integrating a resource-based approach in order to explain the reasons for resorting to syndication.
- *The geographical proximity* between the Venture Capitalist and senior management (Lerner (1994), Sapienza et al (1995) (1996)). If we bear in mind the low staff levels in the Venture Capitalist, it is evident that geographical proximity can facilitate the implementation of a partnership.

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<sup>3</sup> In a study on British venture capitalists, Chiplin et al (1997) explain the practice of syndication in MBO and MBI operations.

## **12 The specific features of the board of directors in venture capital financing operations.**

As the power-holder within the venture, the board of directors is made up of board members that reflect the nature and geography of the capital. From the context of a start-up, the composition of a board of directors merits a clarification in the sense that it integrates the principles on which the venture is governed in its formation and organisation (which certain large ventures still apply badly<sup>4</sup>): The presence of independent board members, some even foreign, high levels of involvement of the board in the life of the venture...

There are many missions that involve the board of directors: on the one hand, to appoint, supervise and reward senior management, possibly dismiss senior management if they do not observe the objectives issued by the shareholders and, on the other hand, to ratify and monitor important decisions taken by senior management (Fama and Jensen (1983)). Numerous studies have defined the structures of boards of directors in entrepreneurial ventures (Lerner (1995), Hermalin and Weisbach (1998)). Baker and Gompers (1999b), within the context of research carried out on the boards of directors of 1553 entrepreneurial ventures (433 of which were financed by venture capital), demonstrated the active role played by venture capital within the board of directors. Gompers (1996) has demonstrated that young venture capitalists (and a priori those that are less experienced) had less of a presence in the boards of directors than more established venture capitalists. As an influential player, venture capital models the composition of the board of directors (through the reduction of the number of specialist board members<sup>5</sup>) and serves to counteract the control of senior management (through the reduction of the number of internal board members). There are two opposing approaches as regards the position of the board of directors:

- The first is linked to the agency theory, in which the principal function of the board of directors is to control the actions of senior management, bearing in mind the objectives assigned to the latter. This subscribes to a disciplinary function: ranging from the evaluation of performances, selection of the remuneration of senior management, to their possible dismissal. Within this context, the composition of the board and the nature of the board members (differentiation between internal and external board members, the level of independence as regards senior management...) are two factors that serve to legitimise the board of directors.
- A second, more extensive approach regarding the role of the board of directors. Zahra and Pearce (1989) define two additional functions alongside the control function:
  - The service function: the board of directors serves as the link between the venture and its environment: establishing contacts, implementing boards...
  - The strategic function: it can assist in the implementation of the venture strategy.

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<sup>4</sup> For a study on venture governance practices for large ventures, we can refer to the works of Charreaux (1997), Gomez (2001), Parrat (1999), Maati (1999), ... .

<sup>5</sup> The importance of monitoring, the contacts made by the venture capitalist, are also elements that allow the venture to reduce the number of specialist board members.

The board of directors can influence performance on the basis of four inter-dependent attributes: its composition (size of the board<sup>6</sup>,...), its characteristics (these are linked to the background of each of the members : training, age, functions...), its organisational framework (number of committees and committee types...) and the monitoring approach or the operating mode (frequency of board meetings...). This approach is an integral part of different theoretical fields such as the resource dependency theory (Pfeffer and Salancik (1978)) and a set of theoretical models based on social and behavioural relations applied to venture capitalism: the works of Sapienza and Koorsgaard (1996) integrate the venture capitalist/senior management relationship into the procedural justice theory. Cable and Shane (1997) have studied the same relationship within the context of game theory.

## **II The moral hazard**

Once the contractor has chosen his project, he may opt to adopt a strategy that suits the interests of the venture capitalist, thus submitting the latter to the risk of moral danger. This danger can take four main forms according to Kaplan and Strömberg(2000):

- Under-investment;
- The quest for private interests, to the detriment of financial interests;
- Extravagant expenses;
- The venture capitalist being taken hostage through the threat of the project being abandoned for another venture.

Each of these eventualities are considered by the venture capitalist, who takes precautions in order to avoid being the victim of a « hold-up ». Firstly, we will look at the models and reasons giving rise to these situations and we will then analyse the tools used by venture capitalist in order to protect himself from these risks.

### **2.1. *Conflicting situations***

As we have seen, these situations can relate to various behavioural patterns on the part of the contractor:

#### **2.1.1 *Under-investment***

The venture capitalist would expect the contractor to take any action that is likely to increase his wealth. In order to be successful, the latter must invest the sums required for the optimum development of the project, but may perhaps suffer from short-term « short-sightedness » brought about by the venture capitalist's demand for profitability (Hellmann (1994)). R&D investments, in fact, are significant both in terms of the sums involved and the success of the project, and their profitability can only be future and uncertain. Furthermore, in order to achieve a short-term profitability, the contractor may be tempted to sacrifice these investments, which could compromise the future of the venture in the long-term.

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<sup>6</sup> Rosenstein et al (1993) demonstrated that the boards of directors of high-tech firms financed by venture capital were small in size (5 to 6 members) in comparison to those with distributed capital.

### **2.1.2. The pursuit of private interests**

The objectives of the contractor are not the same as those of the venture capitalist when executing his project. Hellmann (1994) specifies that the entrepreneur is concerned with his human capital: scientific interest, the prestige of his business, the market valuation of his work, etc. The loss in human capital would always be greater than the monetary gains he would make from liquidation, which would lead him to continue to pursue his project even if it proves to be unprofitable (Hellmann (1994), Cornelli and Yosha (1997)).

### **2.1.3. Extravagant expenses**

Kaplan & Strömberg (2000) use the term « stealing theories », according to which the contractor cheats the venture capitalist and destroys value. This destruction can take various different forms, as detailed by Barney et al (1994) : Research and Developments costs that are too high, an excessive salary for the contractor, keeping poorly performing managers on his team. These practices lead to the contractor «window-dressing» in order to trick the venture capitalist (Cornelli and Yosha (1997)).

### **2.1.4 The threat of abandonment of the project**

Hart and Moore (1994) talk of inalienable human capital, based on which the value of the firm, together with the contractor, is greater than its liquidation value. The contractor, however, cannot be committed to not leaving the venture. Here, the risk is defined as a competitive risk by Barney et al (1994) and destroys the value, on the one hand, by increasing the competition faced by the financed venture and depriving this venture, on the other, of the skills of the retired manager.

## **2.2 Prevention tools**

Aware of the risks surrounding their participation, venture capitalists implement a range of elements that are likely to prevent the occurrence of these conflicting situations that destroy value. Hellmann (1994) proposes 5 key factors for resolving these conflicts:

Sequential financing;

Using convertibles;

Remunerating senior management;

Implementing strict relations with the contractor;

Retaining voting rights and rights of representation on the board.

We will analyse these solutions, focusing particularly on the mechanisms that serve to prevent the destruction of value.

### **2.2.1. Sequential financing**

Although projects require long-term financing, the informational asymmetry and uncertainties surrounding the project prevent the venture capitalist from taking a long-term financial commitment (Hellmann (1994)). Nevertheless, once the project is underway, information becomes widespread and serves to reduce the risks. Establishing financing on the

basis of several phases therefore guarantees long-term financing when projects merit this, but at the same time prevents the venture capitalist from committing himself heavily in projects that aren't viable, since he retains the option to abandon the project (Cornelli and Yosha (1997)).

Repullo and Suarez (1998) note that sequential financing is also a method for « amortizing » past agency costs. The financial requirements of the venture capitalist could imperil the survival of the project during the first stages of its development. Successive financing stages could afford proportionality between these requirements and the profitability of the project. Admati and Pfleiderer (1994) propose an original sequential financing contract, in which the venture capitalist, during the second financing phase, only participates in proportion to the project revenue assigned to him at the end of the first phase. These authors believe that this is the only contract that is likely to guarantee the optimality of the project and its financing.

### **2.2.2. The use of convertibles**

Based on « strip finance » (Hellmann (1994)), these instruments are priority shares convertible into ordinary shares or debentures convertible into shares and differentiate venture capitalists from the banks (Triantis (1998)). Aghion and Bolton (1992) advocates these within the scope of an optimal financing contract, in which the control of the venture reverts to the venture capitalist in the event of insufficient profitability. This control can be transferred by issuing an option on the convertibles, the conditions for exercising this option being contractually determined. As an example, convertible debt allows for the reduction of the risk of window-dressing, according to Cornelli and Yosha (1997).

Bascha (2001) lists the privileged financial instruments of venture capitalists and underlines the major incentive role played by debt convertibles and privileged convertible shares since, after conversion, the contractor remains the sole residual beneficiary of the profits. The benefit of these convertibles lies in the asymmetry of the payments, or rather their capacity to develop the associated payments at the end of the project. If the project proves to be profitable, the contractor will receive larger payments than those received through ordinary shares. Conversely, in the case of failure, his loss will also be greater (Bascha (2000)). The study conducted by Bascha and Walz (2001) confirms the predominance of convertibles in venture capital financing in Germany, since these alone represent close to one third of the financing instruments used on the market.

### **2.2.3. The remuneration of senior management**

Holmström and Rocart I Costa (1986) point out that the method of remunerating the contractor could encourage him to stop being concerned only with his human capital. They propose a « second best way » contract which offers the contractor a fixed decreasing salary which may be interpreted as an option on the value of his human capital. This option may include an investment premium, thereby preventing the risk of under-investment. Possible over-investment would be curbed by capital rationing. Conversely, Harris and Raviv (79), under certain risk aversion conditions and constraints of wealth, establish an optimal contract in which the profit of the venture capitalist is fixed, while residual profits are given to the contractor.

Ravid and Spiegel (1997) show that the contractor is only financed if he has invested a portion of his wealth in the project. Additionally, the existence of stock-options to the profit of the contractor guarantees intelligent borrowing on his part and the convergence of his interests with those of the venture capitalist.

#### **2.2.4. Monitoring**

According to Hellmann (1994), monitoring is perhaps the most important key factor for resolving conflicts. It fundamentally differentiates between venture capitalist financing and market financing. Monitoring is based on very strict relations between the venture capitalist and the contractor. The latter carries the project and works on it while the former finances and participates actively in the management of the project, ensuring the contractor profits from his expertise and his address book. This monitoring allows the contractor to rid himself of ineffective short-term pressures since he knows he will be able to profit from subsequent financing if the project follows its development plan, the likelihood of which is increased by monitoring.

#### **2.2.5. Contractual clauses**

These relate mainly to the separation and allocation of voting rights, profit entitlements, liquidation rights and other control rights such as the representation of the venture capitalist on the board of directors (Hart (2001)). The actions taken can therefore be radical, such as the dismissal of senior management at the beginning of the project (Hellmann (1994)). Control rights and their allocation result in important decisions being made that must be in the hands of the venture capitalist, according to control theories, when the efforts of the contractor can be observed but not verified (Kaplan and Strömberg (2000)), i.e. when the venture capitalist lacks the technical know-how to verify the true progress of the project. Remaining with these authors, we talk of the stealing theory, when the venture capitalist cannot even observe the efforts of contractor (the project is still not at the stage of a beta version or a prototype). In this case, the venture capitalist receives a fixed payment which, if not honoured, may lead to the venture capitalist liquidating the venture. Liquidation rights and their allocation are therefore crucial. Aghion and Bolton (1992) specify that the efforts of the contractor may very well respect the objectives of the venture capitalist, but may not be able to be observed by the latter who must therefore take control in the event of an unfavourable situation. This allocation, however, is not rigid since an increase in performance (in terms of the creation of value) results in the progressive transfer of control and liquidation rights to the contractor, and the venture capitalist only retains his profit entitlements (Kaplan and Strömberg (2000)).

Contractual clauses can also prevent the project being abandoned by the contractor. Thus, the venture capitalist implements non-competition and authority clauses in order to limit the risk of hold-up (Kaplan and Strömberg (2000), Barney et al (1994)).

These instruments available to the venture capitalist are complementary, not substitutable, and are used simultaneously in financing contracts (Hellmann (1994), Kaplan and Strömberg (2000)).

## **Conclusion**

The specifics of venture capital operations are therefore borne of the risks they carry and evaluations that can be made. The informational asymmetry that is typical of this type of financing subjects the venture capital entity to numerous constraints in terms of ex ante and ex post assessment of the creation of established or potential value. In order to best arbitrate between risk and profitability, venture capitalists undertake a rigorous project selection process, implementing governance tools that are likely to guarantee their objectives. This global vision can be enriched by a more detailed analysis which, for example, would permit typologies of venture capital entities to be created, according to privileged governance tools, the predicted ex ante output modes or the ex post output modes effected. These typologies would afford the identification of the principal types of venture capitalists and their governance operating modes.

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