



Investment and returns in successful entrepreneurial sell-outs



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ABSTRACT

This paper examines returns to capital invested in new ventures. Across theoretical lines of inquiry, outcomes of new venture growth, valuation, and consequent return to entrepreneurs are generally assumed to be a function of access to equity capital. Drawing on a hand-gathered dataset comprising the universe of 3160 private firms acquired by U.S. publicly-traded firms during the years 1996–2006, we analyze a population of heterogeneous investment profiles with clear terminal valuations, lifespans, and distributions to entrepreneurs. The results paint a picture of steeply diminishing returns to invested capital, where the primary benefit of equity investment is accelerated liquidity, not terminal value of the venture or entrepreneur returns.

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1. Introduction

The assumption of capital constraints on entrepreneurs frames much entrepreneurship research (Holtz-Eakin et al., 1994) with the general expectation that in a new venture more cash is better. But owing to limited availability of data on the terminal liquidity value of new ventures, empirical examinations of the *ultimate* merits of this assumption are scarce. Researchers have far more knowledge about the start-up process and ongoing maintenance of ventures than they have about the eventual harvested value (DeTienne, 2010; Mason and Harrison, 2006). In a recent review Carter (2011) concludes that, “[F]ew entrepreneurship scholars have focused on the individual financial rewards and consequences of venture creation...” (p.40), and “Despite theoretical interest in the returns to entrepreneurship, there has been little supporting empiricism.” (p.41).

2. Literature

This study is most directly related to a very small set of empirical papers that deal with the financial rewards to entrepreneurship at exit. Hall and Woodward (2010) analyzed the returns to entrepreneurship for the minority class of entrepreneurs who receive venture capital financing. Using a remarkable dataset that captures virtually all the VC investments made in the U.S. over a 20 year period, they find that approximately three quarters of VC-funded entrepreneurs make

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nothing at exit, while a few make very large returns, resulting in a mean reward of around \$6million at exit. The disadvantage of studying VC-backed firms is evident in that ventures selected for VC investment are atypical of the general population and further skewed by the strategies VCs use to reach exit (Arora and Nandkumar, 2011). Related work focusing on liquidity through IPO (ex: Stuart et al., 1999) is narrower still, offering insights to that class of firm that (a) typically receives venture financing and (b) goes on to issue a public equity offering. This represents about .05% of all new ventures (Rao, 2013). Two papers by Brau et al. (2003; 2010) stand out as they investigate primarily non-VC-funded ventures. In one study, Brau et al. (2003) relate the determinants of the decision to IPO a venture versus conduct a private sale and in follow-on research Brau et al. (2010) study harvesting strategies of ventures that simultaneously pursue IPO and private sale versus only one or the other. Neither study considers the rewards to entrepreneurs at exit or the financial strategies used to achieve them.

Investigations that consider dependent variables beyond new venture valuation at liquidity frequently also adopt a capital constrained perspective. Work related to new venture growth benefits from a wider range of available dependent variable constructs, connecting capital access with new firm scaling along measures such as turnover, assets (Desai et al., 2003) and employees (Davila et al., 2003). Although the relationship between capital and growth is generally positive, there is no work that closes the loop to determine whether the capital used to drive growth is meaningful in the ultimate valuation of the venture, or the eventual returns to the entrepreneur (Davidsson et al., 2009).

Work seeking to understand the overall rewards to entrepreneurship is also incomplete. Attributable in part to limited data availability, Moskowitz and Vissing-Jorgensen (2002:745) state that “[E]ntrepreneurial investment, which represents a substantial fraction of many investors’ portfolios, is relatively understudied and not well understood. Specifically, little is known about the aggregate return to entrepreneurs’ equity investments.” Of the two monetary components of rewards, earnings from trading (including personal remuneration) has been explored in the economics literature usually in comparison to wage work (Åstebro, 2013; Hamilton, 2000). The second component – harvesting ownership in an enterprise at exit – has received less research attention and is focused on VC funded firms (Hall and Woodward, 2010).

3. Data

To investigate the relationship between capital constraints and the ultimate rewards to entrepreneurship we assembled a unique hand-gathered dataset comprising the entire universe of 3160 private firms acquired by U.S. publicly-traded entities during the years 1996–2006. The full inventory of sources and model variables is presented in Table 1.

The Thomson & Reuter’s transaction data were complemented with details relevant to this study extracted from other sources. Capturing data on invested capital required analyzing the SEC filings associated with each and every acquisition. One of the authors, a former professional accountant, reviewed the financial statements of the sellers in those filings, separating the retained earnings and paid in capital details from the balance sheet. These data offered sufficient detail on 2579 of the ventures that we could include them in our study. From the individual state business databases, we identified a seller incorporation date for 2125 of the ventures. We thus performed our analyses on the 1847 ventures for which we could identify both financial data and incorporation date. Finally, we gathered contextual data regarding VC activity in the sellers’

Table 1
Variables.

Name	Definition	Data Source
Exit year	Year seller acquired	Thomson & Reuter's done deals database (www.donedeads.com)
Valuation	Total value of acquisition	
Shareholder equity	Total shareholder equity of seller acquisition	SEC 8K filings (http://edgar.sec.gov)
Assets	Total assets of seller at acquisition	
Revenue	Annual revenue of seller at acquisition	
Retained earnings	Accumulated surplus (deficit) of the seller from incorporation to acquisition	
Paid in capital	Total invested capital received by seller prior to acquisition	
Total cash out	Total cash received by seller at acquisition	
Inc year	Year seller incorporated	State Databases (MN ex: mblsportal.sos.state.mn.us)
Seller population	Seller state population at incorporation	Longitudinal business database (www.census.gov)
Exit VC activity	VC disbursements in the buyer state in the acquisition year	PriceWaterhouseCoopers Moneytree and NVCA database (www.pwcmoneytree.com)
Founding VC activity	Average VC disbursements in the seller state over 3 years around incorporation year	
Industry	SIC code of seller	Environment, health and safety (www.ehso.com)
Years	Years from incorporation to acquisition	Calculated
Average growth rate	Revenue of seller at acquisition divided by years	
Deal profit dollars	Total cash out–paid in capital	
Return on capital	Total cash out/paid in capital as a function of years	
Same state	Binary: 1 = buyer & seller in same state	
Tech bubble	Binary: 1 = tech firm between 98 and 00	

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