



Legal jurisdiction, director liability law, and venture capitalists' equity stakes in Africa



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ABSTRACT

This article empirically investigates whether shareholder protection features of countries' legal jurisdictions influence portfolio companies' venture capital and private equity stakes purchased by general partner firms in Africa. Results indicate general partners purchase lower equity stakes in French civil law, relative to Common law systems, when director liability laws are weak and higher equity stakes in the former when laws are stronger. This supports theory arguing firm level monitoring and shareholder protection, measured by director liability laws, are substitutes on the continent. Results also indicate private benefit extraction gains influence general partner monitoring and portfolio company owners' effort incentives.

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1. Introduction

This article empirically investigates whether shareholder protection features of legal jurisdictions in Africa influence the level of venture capital or private equity stakes purchased by general partner (GP) firms investing in portfolio companies on the continent.¹

African legal jurisdictions, which are Common, Civil, or Pluralistic (Hart, 1995; La Porta et al., 1997; Parker, 2007), are exogenous.² They were transplanted (Berkowitz et al., 2003) as "... countries involuntarily adopted them through colonization or conquest by the European countries to which they owe their legal origin and even... where countries adopted their legal jurisdiction freely as in former Spanish colonies, the crucial consideration was language and... broad political stance of... law rather than... treatment of outside investors" (La Porta et al., 1998; Siems, 2007).

Effects of institutional environments on outside investors' equity stakes and corporate governance in emerging markets (Claessens and Fan, 2002) has been of interest for a long time (Berle and Means, 1932). Since Jensen and Meckling (1976) outlined how moral hazard and monitoring are positively related to outside investors' equity stakes various theories have

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¹ Venture capital and private equity investments are made by general partner (GP) firms, who are intermediaries that directly invest in unlisted portfolio companies through funds using equity or quasi-equity instruments, on behalf of limited partners, who are institutional investors such as pension funds and university endowments. They actively manage these investments with an explicit strategy to exit in the medium-term (Sahlman, 1990). Investments by wealthy individuals (angel investors), who use their own money to directly finance these portfolio companies, are beyond the scope of this article due to data paucity.

² Common law countries include those colonized by the United Kingdom. German civil law countries include those colonized by Germany, and French civil law countries include those colonized by Belgium, France, Italy, Netherlands, Portugal, or Spain (Berkowitz et al., 2003). Pluralistic legal systems are a combination of these.

attempted to explain how shareholder protection, an institutional environment component, influences equity stakes. Some argue the two are negatively related (Aghion and Bolton, 1992; Shleifer and Vishny, 1997; Himmelberg et al., 2000; La Porta et al., 2000). Others argue the relationship is positive, U-shaped, or ambiguous (Burkart et al., 2003; Castillo and Skaperdas, 2005; Burkart and Panunzi, 2006; Holderness, 2011; Stepanov, 2013).

Burkart's and Panunzi's (2006) static principal-agent model focuses on interaction between legal shareholder protection, monitoring, and portfolio company owners' effort incentives. When shareholder protection and GP firm level monitoring are complements, GP firms' equity stakes and shareholder protection are always negatively related. However, when they are substitutes, a decrease in shareholder protection increases GP firms monitoring incentives. This reduces portfolio company owners' effort incentives to create joint surplus because their private benefit from engaging in moral hazard falls.

If GP firms' monitoring incentives dominate, they decrease their equity stakes to preserve portfolio company owners' effort incentives. In this case, weaker legal shareholder protection and lower GP firms' equity stakes are positively related. If portfolio company owners' effort incentives dominate, GP firms can increase their equity stakes while preserving owners' effort incentives. In this case, weaker legal shareholder protection and lower GP firms' equity stake levels are negatively related. The article's objective is to empirically resolve theory's ambiguity by testing the null hypothesis that legal jurisdictions' shareholder protection features have no influence on GP firms' equity stake levels.³

Empirical evidence on effects of shareholder protection on outside investors' equity stakes can be distinguished by whether the analysis relies on public or private equity data.⁴ Evidence on its effect on public equity depends on the analysis level adopted. While authors using country level data find shareholder protection and outside investors' public equity stakes are negatively related (La Porta et al., 1998, 2006; Berglöf and Pajuste, 2003), others using firm level data find the relationship is positive or non-existent (Holderness, 2009).

This article focuses on venture capital and private equity on a continent where GP firm level monitoring is particularly important due to severe information asymmetries.⁵ While empirical studies exist analyzing the effect of legal jurisdictions or shareholder protection on venture capital or private equity investment or investors' ownership ratios (Jeng and Wells, 2000; Kumar and Orleck, 2002; Allen and Song, 2003; Kaplan et al., 2007; Bonini and Alkan, 2011; Hall, 2012; Groh and Wallmeroth, 2016)⁶; none, to my knowledge, do so for Africa.⁷

It also explores whether private benefit extraction gains influence portfolio company owners' effort incentives by distinguishing expansion venture capital, where portfolio companies have high upside potential via rapid growth, from seed, start-up, or early venture capital where they are incipient, lacking extensive financial or track records; and private equity where they are mature with extensive financial records, tangible assets, and track records (Sahlman, 1990; Fenn et al., 1996).

In summary, the article finds GP firms purchase lower venture capital and private equity stakes in weaker legal systems when shareholder protection, measured by director liability laws, is weak and higher equity stakes in weaker legal systems when these laws are stronger. This supports theory that director liability laws and GP firm level monitoring are substitutes in Africa.

It also finds when director liability laws are weak, GP firms purchase relatively higher stakes at expansion venture capital than private equity stages. As these laws strengthen GP firms purchase relatively higher stakes at the private equity stage. This suggests where director liability laws are weak and private benefit extraction gains are high, portfolio company owners' effort incentives dominate monitoring incentives. As these country level laws strengthen, monitoring incentives dominate.

The findings inform efforts to improve laws to increase venture capital or private equity activity (EMPEA, 2015). Specifically, strengthening director liability laws enables GP firms' equity stakes to increase in weaker legal jurisdictions. Higher participation in potential upside gains may increase private equity and venture capital flows to Africa, which are relatively lower than other regions despite Sub-Saharan Africa ranking top three in most attractive emerging market destinations to limited partners since 2013 (Brander et al., 2015; Schlapinski, 2016). This has implications for economic growth and individual welfare on the continent because venture capital and private equity influence innovation, productivity, and employment (Kortum and Lerner, 2000; Engel and Keilbach, 2007; Davis et al., 2014). However, private extraction benefits would dampen flows even with stronger laws where potential gains are high.

Following this introduction, Section 2 describes the data. Section 3 describes the empirical model and estimation strategy. Section 4 presents results and discusses findings. Finally, Section 5 concludes.

³ See Appendix A for portion of Burkart's and Panunzi's (2006) theory that leads to this ambiguous prediction

⁴ Public equity refers to claims issued by listed companies, rather than those issued by government agencies.

⁵ Legal jurisdiction effects on private equity is a separate strand of literature from its effects on public equity, which was the focus of seminal empirical work on effects of law on finance (La Porta et al., 1997, 1998), or its effects on investments by listed companies (Lskavyan and Spatareanu, 2011).

⁶ Hall's (2012) ownership ratio indirectly measures outside investors' equity stakes by amount of finance raised divided by pre-money valuation in a financing round. Claessens and Laeven (2003) find empirical support for the positive relationship between finance raised and outside investors' public equity stakes. However, Lins (2003) finds a positive relationship between these equity stakes and listed company valuations, which is exacerbated by weaker shareholder protection. Although this article lacks access to valuation data, it captures the inverse relationship between valuations and GP firms' equity stakes defined by Hall (2012) by measuring equity stakes directly.

⁷ In a dataset that includes three African countries, Lerner and Schoar (2005) show the range of equity stakes held by GP firms is relatively highest in French civil law jurisdictions.

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