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Investment Risk Allocation and the Venture Capital Exit Market

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ABSTRACT

This study provides evidence on how venture capitalists' (VCs') allocations of capital to riskier investments, as measured by the proportion of early versus late-stage investment in an industry, are linked to exit market conditions. Prior research has primarily focused on how VCs adjust aggregate investment to public equity market conditions. We develop a more inclusive measure of exit market conditions that accounts for recent secular changes that have affected the industry return structure, specifically, the sharp rise in the number of failures and M&A relative to IPO exits. We show that the dollars gained relative to dollars lost in recent exits and failures are significantly positively related to VCs' allocations to early-stage companies over the period 1990-2008. The changes in allocations are large enough to have an effect on the availability of funding for early stage companies. In sum, our evidence shows that exit market conditions have a significant and economically meaningful influence on VCs' allocations to riskier investments.

Keywords: Venture capital; risk allocation; early stage investment; M&A exits; IPO exits

JEL Classification: G24

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