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The dark side of independent venture capitalists: Evidence from Japan

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ABSTRACT

Using Japanese firms that went public during the period 1998–2006, we find that independent venture capitalist-backed IPO firms are significantly younger and smaller than IPO companies backed by venture capital firms that are subsidiaries of financial institutions. IPOs backed by independent venture capitalists also tend to use less reputable underwriters and go public on stock exchanges with less strict listing requirements due to their immaturity. Young and small IPO companies experience significantly greater underpricing and poorer long-term operating performance. Taken all together, independent venture capitalists make lower quality companies go public than finance-affiliated venture capitalists.

1. Introduction

Diversification by financial institutions potentially engenders conflicts of interest as well as certification effects. This idea has motivated previous studies to extensively investigate the consequences of bank entry into underwriting and securities businesses (Kroszner and Rajan, 1994; Puri, 1994, 1996; Gande et al., 1997; Konishi, 2002; Takaoka and McKenzie, 2006; Kang and Liu, 2007). Puri (1994, 1996) investigated the US bond market before Glass–Steagall, and presents evidence of the certification hypothesis.[3] In contrast, Kang and Liu

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[3] The certification hypothesis is also supported by several researchers (Gande et al., 1997; Kroszner and Rajan, 1994; Konishi, 2002).

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(2007) find that as Japanese banks enter the securities business, they discount prices of corporate bonds to attract investors, thereby generating conflicts of interest that harm issuers.[4]

The outcome of financial institutions' diversification has also been investigated for the corporate initial public offering (IPO) process. In several non-US countries such as Germany and Japan, banks and securities firms enter the venture capital industry and help young emerging companies go public (Black and Gilson, 1998; Hamao et al., 2000; Wang et al., 2002; Kutsuna et al., 2007; Tykvova and Walz, 2007; Bottazzi et al., 2008; Arikawa and Imad'eddine, 2010). It is well documented that venture capitalists (hereafter referred to as VCs) provide monitoring and support in various aspects of management to young, immature firms; as a result, VCs potentially have certification effects (Gorman and Sahlman, 1989; Lerner, 1994, 1995; Gompers, 1995; Hellmann and Puri, 2002; Hsu, 2004; Baum and Silverman, 2004). Numerous empirical studies show evidence that VC-backed IPOs experience less underpricing and better long-term performance (Barry et al., 1990; Megginson and Weiss, 1991; Jain and Kini, 1995; Brav and Gompers, 1997; Cai and Wei, 1997). The certification hypothesis gives rise to the prediction that bank-affiliated VCs that can access information accumulated by the parent bank, have stronger certification effects. However, existing studies show that independent VCs (hereafter referred to as IVCs) add more value to emerging firms than finance-affiliated VCs do (Gompers and Lerner, 2000; Van Osnabrugge and Robinson, 2001; Wang et al., 2002; Tykvova and Walz, 2007; Bottazzi et al., 2008). Specifically, IVC-backed IPO firms experience smaller underpricing (Wang et al., 2002) and better long-term performance than those backed by non-independent venture capitalists (Hamao et al., 2000; Wang et al., 2002; Tykvova and Walz, 2007). Hamao et al. (2000) argue that conflicts of interest exist when the lead VC serves as the lead underwriter during the IPO process.

This paper is principally intended to present a new aspect of finance-affiliated VCs (hereafter referred to as FVCs), or what we term the dark side of IVCs. Specifically, we propose the hypothesis that IVCs induce immature firms to go public, which is associated with greater underpricing and poorer long-term performance. There are several reasons that lead to this hypothesis. In general, firms must be performing well and thereby establish a reliable reputation in order to be able to access external financing (Diamond, 1989; Chevalier and Ellison, 1997; Sirri and Tufano, 1998). The importance of reputation holds true for VCs that seek financing from external capital markets (Sahlman, 1990). Gompers (1996) argues that young VCs that lack an acceptable reputation tend to make immature firms go public for the sake of establishing their own reputation (the grandstanding hypothesis). As for young VCs, IVCs are also likely to have a strong incentive to improve their reputation because they typically create limited partnership funds and need to finance new funds (Wang et al., 2002). Significantly IVCs have to rely on external capital markets because they have no affiliations with financial institutions. In contrast, FVCs finance mainly from their parent institutions (or an internal capital market) and have less need of external financing. The difference in financing environments is likely to affect VCs' grandstanding incentives.

Secondly, Hellmann (2002), Wang et al. (2002), and Hellmann et al. (2008) suggest that bank-affiliated VCs (hereafter denoted by BVCs) invest in start-ups to increase the chance that their parent banks can supply loans to the firm. This strategic incentive will make BVCs more risk-averse than IVCs; BVCs are likely to invest in and cause matured companies to go public; this type of action provides valuable lending opportunities to their parent banks. The BVCs' strategic objective is also likely to reduce a firm's incentives to go public for financing opportunities. If BVC-backed non-listed companies can sufficiently borrow from the BVC's parent banks, these firms will not have an urge to go public for external financing opportunities (Miyakawa and Takizawa, 2012). In contrast, IVC-backed firms will have strong incentives to go public to increase their opportunities of getting external financing. Finally, IVCs will have a less strong competitive advantage in the capital market where financial intermediaries have dominant power. In that environment, IVCs will be forced to invest in and make relatively low quality companies go public.

We studied a sample of Japanese firms that went public during the period 1998–2006 to investigate whether IVCs do indeed make more immature companies go public than FVCs. In Japan, many venture

[4] Bank entry into the underwriting business potentially generates various outcomes. Gande et al. (1999) find that underwriter spreads and ex-ante yields have declined significantly with bank entry, suggesting that bank entry makes the underwriting market more competitive. Takaoka and McKenzie (2006) find that the entry of bank subsidiaries into the Japanese underwriting market for straight corporate bonds has led to a significant reduction in underwriting commissions. Yasuda (2005) finds that there is a significant fee discount when there are relationships between bond-issuing firms and commercial banks that underwrite the issue.