

Why do(n't) VCs go public? An analysis of funding decisions in the German venture capital industry

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Principal Topic

Venture capital firms generally develop young companies to a stage where they can either sell the company in a trade sale, or take the company public and achieve the exit through an IPO. Given that the latter alternative seems to be the preferable alternative to earn money, the question arises why venture capital firms themselves tend to be organized as private companies that are not listed on a stock exchange. This is in any case true for the U.S. where legal constraints make such an option impossible. A public listing of a VC company is only possible in the form of a Small Business Investment Company (SBIC); in this case, however, the required standards and operating procedures for an SBIC are differing from those of a limited partnership VC such that a SBIC has simply to be classified as a different business model. In contrast, in Japan and Germany, where the legal constraints are less restrictive, there are no a priori reasons why an IPO should not be a viable option for a VC company. And indeed, in Japan - where the venture capital industry is still in its infancies, due to an underdeveloped start-up scenery - we currently find five VCs that are publicly listed. In Germany nine venture capital companies went public during the Internet boom in the late 1990s. However, all of those VC companies, except for one, had quit business, de-listed or changed the business model by spring 2003. Our research aims at finding out the reasons for this, and why venture capital firms do not seem to be suitable for public financing. The relevance of our research question is supported by the fact that, in the 1990s and the early 2000s, the issue of going public became also hotly debated in other industries where companies are traditionally organized as private partnerships. One example is the management consulting industry where at least Accenture took the final step and got listed at the New York stock exchange in July 2001. Another example is the investment banking industry where all major players changed their business model, with Goldman Sachs as a late follower who made the IPO decision after discussions within the company for more than 30 years. From this perspective, the private partnership model of venture capital firms should not be taken for granted: The possibility of an IPO of those firms deserves a theoretical discussion, and the experiences which, e.g., the German VC companies made in this regard should be carefully evaluated.

Methodology/Key Propositions

Three main questions set the guiding lights for field research: 1. Are venture capital investments suited for public trading in the light of its specific investment characteristics? 2. Do basic conditions of stock markets allow trading of venture capital stocks? 3. Do venture capital business requirements and its modus operandi fit in the stock market? To explore these questions, company founders were interviewed in-depth, and focused interviews on key aspects of their funding decision were conducted. However, not only the funding decision was analyzed but also the modus operandi of fund management. In order to receive the full picture, listed funds as well as limited partnership funds were considered. In the case of listed VC funds, additional focus was laid on analyzing reasons and root causes for de-listing or change of business model. A total sample of eight case studies was conducted.

Results and Implications

Three main reasons were identified as root causes for why German VCs failed to operate successfully as publicly listed companies: First, the corporate governance of listed VCs in Germany was not suited to overcome the principle-agent problems inherent in the VC business. Unlike limited partnership VCs, control, monitoring and incentive systems were completely insufficient to motivate and steer management on a course that was in the interest of shareholders. However, these problems could be overcome by adequate legislation or stock

exchange regulations. The second reason for the failure of listed German VCs is an asset allocation problem for investors, which is connected to public trading of VCs. The investors expect to invest in 100% venture capital. However, at the time of the IPO, the investors get cash deposited in a bank instead of venture capital. The fund needs time to invest the raised money and thus to achieve the allocation to the desired asset class. In contrast to limited partnership VCs where the committed capital is only paid in when the fund invests in start-ups, listed VCs receive all of the raised capital by the time of the IPO. Along with the misallocated capital comes a lower-than-expected return on investment for the invested funds since cash market yields are significantly lower than venture capital. The third root cause for the failure of German publicly listed VC funds is a change of investment characteristics that occurs when VC funds are listed. Limited partnership VC funds are "alternative investments" because their returns correlate only weakly with the stock market. Publicly traded VC funds lose this characteristic specification of venture capital. The returns correlate strongly with stock market returns which makes the investment unsuitable for diversification of a portfolio. The major reason for investment in VCs thus falls away. With these findings the paper constitutes a systematic approach to the decision making of venture capitalists as entrepreneurs, and encourages further research in this field.

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