

# Risk management, screening and value creation in venture capital syndicates

Asif Siddiqui<sup>1</sup> and Kunal Sengupta<sup>2</sup> and Jian Hong<sup>3</sup>,

Investment in young ventures involves significant [.] for the venture capital fund managers, especially given the investors' risk profile. Diversification of fund portfolio is a common method of mitigating some risk which could lead to the formation of venture capital equity syndication. Nevertheless, the formation of syndication serves as mutual endorsement regarding a venture investment decision which in turn reduces the investment risk through information aggregation. On this premise we empirically investigate how financial position of the venture capitalists influence syndication decision. Further, we suggest that the syndicate's endorsement about the quality of a venture leads to venture selection bias and we empirically investigate its implications on the venture's performance.

Key words: Venture capital, Syndication, Risk, Screening

JEL classification: G32, G24, L22, L26

## 1. Introduction

Despite the risk and uniqueness of venture capital investment, venture capital market has grown significantly in the industrialized countries in the American, European and Asia Pacific markets led by the US. Australia in the last two decades has emerged as a major venture capital market in the Asia Pacific region. In recent times, venture capital has been recognized as an asset class in the regular portfolio of the traditional fund managers and investors. Consequently, the fund of funds managers, pension funds and as well as banks and other financial institutions, beside the traditional venture capitalists are increasingly investing and participating in the venture capital market while adopting some strategies and practices from the corporatized public equity market. It is generally understood that the venture capital fund managers would invest in young companies with significant growth potential which nevertheless involve high levels of risks. While expecting future returns, the venture capital fund managers are initially required to manage the risk, especially given the fund available and the deal flows in the market. The natural response to risk management is portfolio diversification and investment specific risk reduction. Given the growth potential and the financial need of the individual ventures, risk diversification is not a straight forward choice. The under funding may delay or depress the growth of the venture, while diversifying a fund's portfolio would require conforming to certain financial limit in one individual company. Given

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<sup>1</sup> PhD candidate, Faculty of Economics and Business (Corresponding author)  
Research Centre (Level-2), H69 Economics and Business Building  
University of Sydney, NSW 2006 Australia

Email: [asid9246@uni.sydney.edu.au](mailto:asid9246@uni.sydney.edu.au), Phone: +61409340484

<sup>2</sup> Professor, Faculty of Economics and Business

<sup>3</sup> Lecturer, Faculty of Economics and Business

this complexity in venture finance, one natural choice for the fund managers would be formation of equity syndications where each of the syndicate members have the opportunity to diversify the portfolio risk as well as provide adequate funding to realize the potential growth of the young venture. Nevertheless, the formation and management of syndication is subjected to significant transaction and agency cost. Thus, if a venture capital or private fund manager could have the financial flexibility to provide all the necessary funding for an appropriate venture, it may avoid looking for potential syndicate partner. Thus financial position of the funds combined with strategic risk diversification requirements will be the initial drivers of syndication decision.

Once the portfolio risk is taken care of, the fund managers would reduce individual investment risk. The young (seed/ start up & early stage) companies seeking venture capital are often based on new ideas, introducing new products with no marketing track records. The company management could be professionally inexperienced and the company may not be generating any considerable cash flow. A venture capitalist may not have the key information about the venture and may not be able to predict the level of efficiency and cooperation it could obtain from the founders. Thus, the venture capitalist must obtain some credible signals to screen the venture's prospect. Such information and signals about an individual venture would be private in nature and the venture capitalist can obtain information from selective sources including the fellow professionals who might know the founders or the venture. The venture capitalists have to assess the risk and future returns, value the business and the equities tentatively before making the investment decision. The situation could be intense time to time given the deal flows and competition. Delay or failure to make an assessment about a prospect deal could lend the deal to the hands of competitors. Formation of syndication with similar investors would be useful in this situation from several perspectives. First, the syndication could potentially aggregate information and make a better judgement about the company. Thus, each of the syndicate members could reduce individual investment risk while diversifying portfolio risk. They can potentially avoid competition and bargain collectively. In another situation a venture capitalist may have made a small investment in a young company to obtain the option to refinance the project if required. However, as the company grows the venture capitalists may require additional finances and/or other resources which it could obtain from another co-investor where the future financing rounds get syndicated. The need for a syndicate partner could simply arise from the lead venture capitalists capital constraints.

In this paper we investigate how the syndication decision is affected by the risk diversification and capital constraints or financial circumstances of the venture capital fund managers. We empirically test the probability of a venture investment round being syndicated under different financial circumstances and see to what extent syndication decisions are driven by risk management, portfolio positioning and evolving capital constraints. Although, it has been indicated in the literature that venture capitalists may syndicate to mitigate/ diversify portfolio risk (Mike and Wright 2003, Manigart 2006) it has not been empirically explored to what extent this may occur. In this paper, we take the initiative which is a fairly complex task given the information and data available

and other controlling factors. As in the process of venture selection, the potential co-investors may aggregate information and endorse each others decision (Lerner 1994, Stuart 2001) it is expected that the good quality ventures are likely to receive syndicated investments. The ventures which receive syndicated investment in the later round must also provide appropriate signal about the quality of the venture to the new co-investors. We examine the implications of the selection process and its impact on the venture performance.

## **2. Literature:**

Venture capital syndication is common, given the nature of the investments and the risks involved. Economics finance and management literature has shed light on the issue especially in recent times. A number of papers were devoted to seek the answer for why venture capitalists syndicate investments. Bygrave (1987) in his pioneering work on syndication emphasized that the role of uncertainty. Lerner (1994) in another pioneering work suggested that obtaining endorsement from the similar venture capitalists in venture selection primarily motivates syndication. Stuart (2002) also suggests that peer reference in the investor network plays a vital role in venture selection. While sharing experience and gathering information to form an informational alliance could be vital in venture selection (Casamatta 2007; Baron 1999) access to specialized knowledge, networks and diverse resources could add value to the venture (Brander 2002, Hochberg 2007). However, Lockett (2001), Wright (2003), also support both financial and resource base motivation for the syndication. Depending on the circumstances the venture capitalists syndication could be driven by more than one reason (Cestone, et al. 2006).

Nevertheless, the formation and management of syndication is complex (Wright 2003) which entails additional agency and transaction cost (Tykvova 2007). Filatotchev (2006) finds that the syndicated investments have higher board dependence involving multiple layers of decision problems. Walske, et al. (2004) also suggests that some syndication could be ill advised leading to undesirable outcomes. Hence, it is perhaps ideal for the venture capitalists to invest alone in a company if there are credible signals about the quality of the venture and there are no capital constraints. Thus we emphasize the risk and capital constraint as a natural driver in syndication.

Sahlman (1990) suggests that funds investors often impose allocation limits on the venture capital fund mangers regarding how much investment could be made in one company as each investment is associated with significant risk, despite the promise of high returns. Manigart et al. (2006) and Lockett (2001) conducted questionnaire surveys in six European countries where the venture capitalists responded saying that the syndication is often motivated by portfolio risk diversification and investment risk reduction. Thus, we expect that capital constraints and risk management would be the primary drivers in syndication and here we initiate an empirical analysis to examine the validity and gauge the extent of the claim.

Further, syndication has often been directly associated with venture performance in literature (Lehman 2006; Hochberg 2007) and it has been

claimed that the venture capitalist syndicate to add value (Brander 2002) to the venture. However, we suggest that the screening of ventures by the syndicates could imply that only the good quality ventures are syndicated. Hence, the syndicated investments are expected to perform better.

### **3. Methodology and Data:**

We propose several hypotheses which relate the venture capitalists' financial position to the syndication decisions as we explore the role of portfolio risk diversification and capital constraints in venture syndication decision. Consequently we study the probability of a venture capitalist syndicating an investment round, given the financial positions of the funds. We control for the risk indicated by the stage, industry and location. We propose a *Logit* model specifying the relation between syndication probability and fund solvency and thereafter identify the relevant variables to test and validate the proposed hypotheses. Similarly, we then analyse the implications of venture selection on the performance where the performance is measured in terms of venture growth and exit.

The initial sample consists of investments made by 261 venture capital firms in 483 Australian companies participating in 3574 rounds of venture related investments. However, we have focussed on the venture related investments in technology related ventures. The data has been obtained from Thompson Reuters which provides the details of the investments as well as the profile information about the venture capital firms, funds and portfolio companies. We also supplement data from Australian Venture capital Association Limited (AVCAL), Australian Venture Capital Journal (AVJ), Australian Bureau of Statistics (ABS) and Australian Stock Exchange (ASX).

### **4. Results:**

We expect the relationship between syndication and a fund's financial positions to be significant. We also expect to find that the syndicates may lead to better performance.

### **5. Implications**

We suggest that the syndication is often an outcome of underlying capital constraints and risk management strategies adopted by the venture capital fund managers whereas syndication may not be desired on its own merit in every circumstance. The performance of the syndicated investments could be explained partially by venture screening and network of the syndicates.

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