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VC funding: must have three to tango

Management consultant **Harry Yuklea** examines the substantial dependency among general partners, limited partners and entrepreneurs in the venture capital field and describes inefficiencies that result when interests of all three players are not in sync.

Don't be misled by the title of this article; it doesn't intend to promote VC financing of dance clubs, nor reveal a new technology that would allow performance of the well-known passionate choreography in trio formation. The only analogy the title would like to suggest is that in VC funding, like in tango dancing, partners must understand each other's role, coordinate their moves and work with the same expectations.

But in contrast to the tango, VC practices are relatively new and evolving. The rules of the game are still open to interpretation, and the *best practice* methodology is not yet well defined, despite the increasing efforts of academics and practitioners to consolidate the accumulated expertise into a structured body of knowledge. Gradually, scientific analysis is replacing urban folklore, methodology is replacing intuition and performance measurements are becoming more informative. The good news is that VC practice is developing into a more sophisticated, better performing and highly professional financial industry. The bad news is all of the above for those afraid of the competitiveness and accountability required in order to operate in mature financial markets.

Another difference from the tango is that venture capital is a game of three. Despite the common belief in entrepreneurial circles, VCs are not the investors in their firm, but rather are highly specialized financial intermediaries,¹ investing funds committed by their investors into risky projects and monitoring the firm on their behalf. Undoubtedly, the VC industry has a major role in enabling high-risk financing. Modern firm theory models² reveal that the presence of monitors increases funding probability of risky projects. In this context the managers, monitors and investors (or, in VC terminology: entrepreneurs, GPs and LPs) are highly dependent upon each other.

This interdependency is best described as a three-sided strategic game:

Investors (LPs) can invest directly in high-risk projects (HRPs) or through a specialized intermediary (GP). Such projects are characterized by severe information asymmetry and moral hazard problems, putting significant monitoring costs on the investor. Since the monitoring cost of the specialized GP is lower than that of the LP diversified investor, investing through the VC interme-



diary is, in general, more efficient economically.

The intermediate financing takes place if players' payoff expectations exceed the alternative option of investing directly. Thus, VC financing is justified exclusively by the capability of the GP to utilize its special expertise in order to invest in better projects at a lower monitoring cost. Obviously, a precondition to VC investments is the existence of a functioning market of HRPs and availability of risk capital through LPs that allow effective *search-and-match* processes to take place. VCs enable more HRPs to match investment criteria on one side, and lower the LP risk premium cost on the other.

Finding the equilibrium outcome of the game implies solving the double set (LP-GP and GP-HRP) of principal-agent, information asymmetry and moral hazard problems. Thus far, the approach of most academics and practitioners has been, somewhat surprisingly, to address each set of problems independently. In reality, however, this is a three-party strategic game where participants try to maximize their utility function simultaneously. In this context, optimally solving each sub-game does not guarantee that the overall outcome is optimal. Following are a few examples:

- **The myopic effect of fund life limitation**

Limiting fund life is an essential element of the LP-GP contract design. This constraint is required in order to minimize potential expropriation of the LP, by forcing the GP to raise additional funds periodically, thus inducing a reputation cost in its strategy. Other providers of risk financing, such as corporate VCs, don't have life span limitations since the expropriation threat does not exist (however, these are characterized by other severe principal-agent problems). A well-designed contract would choose a life span matching project characteristics relating to industry, development stage, etc., but still needs to be finite.

At a glance, the life limitation cost seems to be just an LP-GP contracting clause, and is therefore compensated for by VC management fees and the



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profit sharing mechanism. However, the three-party angle reveals an additional cost of life limitation: the myopic effect it has on GP portfolio management decisions when deciding on continuation or abandonment of investments at different stages in a fund's life.³ This effect takes the form of inefficient continuation of some bad projects and abandonment of some good projects.

The theory, supported also by empirical studies, suggests that this type of inefficiency might be as high as 25 percent from the best possible outcome, a multibillion dollar loss at present levels of VC financing volume. More importantly, it is a Pareto type of inefficiency (where there's room for one or more parties to be made better off without negatively impacting the others), thus *all* parties may be better off by changing their strategy. In simple words, the myopic effect of VC life limitation, not revealed in the two-sided game approach, forces players to leave money on the table, which they could otherwise more efficiently redistribute.

• VC globalization

Globalization trends have an effect on the VC industry. It is not unusual nowadays to find US institutional investors in an Israeli VC that hold equity in an Indian company. Since the availability of risky projects and the supply of risk capital are not geographically correlated, the globalization of financial markets facilitates high-risk investments. The impact of globalization takes place at two levels:

At the portfolio company level, globalization affects supply and distribution channels, human resources and organizational structure. Consequently, the efficient monitoring of global firms requires diversification of skills, which is somehow in contradiction with the high specialization character of the VC firm. At the funding level, globalization allows the cross-border flow of capital, facilitating the project/investor search-and-match process.

For institutional investors, global access to projects improves their diversification. For entrepreneurs, access to foreign capital is a real option on which they can leverage their financing strategy.

The tricky question is what should be the role of the VC in this context? The VC is a *highly specialized financial intermediary* that should focus on specific industries and geographies in order to leverage its expertise. LPs may diversify globally by investing in a variety of local funds. Entrepreneurs may exercise their global capital access option by syndicated investments, without the intermediation cost of the VC. Who needs the VC then?

In the double LP-GP and GP-HRP models, the effectiveness of VC globalization is not observable. However, in the three-party model, globalization affects the portfolio company synergy and

investment syndication cost, and therefore becomes value-creative. Observing and estimating the effectiveness of VC globalization provide incentives for all three players to utilize leverage when value is created, and to avoid it otherwise.

• Benchmarking to "First Best" results

One controversial issue in the VC world is performance measurement. LPs use a benchmarking method based on portfolio net returns to investors. Entrepreneurs (HRPs), on the other hand, rank VCs according to responsiveness and manager added value to the project. Obviously, the two benchmarks are unrelated by construction. Therefore, the overall measurement of VC performance is at least ambiguous, if not misleading. Is the rank of a particular VC the result of GP skills, or does it reflect the characteristics of the portfolio companies? Are good VCs choosing the right entrepreneurs, or is it the entrepreneurs that are choosing the right VCs? How informative is the benchmark rank in predicting future results, given that future search-and-match processes will take place under different conditions? How do industry variances impact the benchmark? The answers to these are unclear at this point. Furthermore, the VC incentive to climb the benchmark ladder varies with exogenous factors, such as capital and project supply-demand conditions. As we learned from the pre/post dotcom bubble experience, in an HRP dominated market, VC decisions are biased toward acquiring projects, while under capital supply constraints the bias changes toward cash preservation. Thus, benchmarking during expansion or recessionary times is not consistent.

The three-player model reveals the interaction between these elements, allowing a benchmark based on the first-best results. VCs are expected to perform less than the first-best outcome, but the rank reflects the relative gap from that reference level, rather than peer VC performance. By analogy, this measurement resembles the handicap method used in golf, where players play against their own previous best results, providing an incentive to continuously improve performance.

My concluding advice to VC dancers is quite simple: whatever your role, never forget that you need two more partners on the floor for full enjoyment. ■

¹ P. Gompers and J. Lerner, *The Venture Capital Revolution*, 2001

² See for example: J. Tirole, *The Theory of Corporate Finance*, 2005

³ E. Kandel, H. Yuklea, D. Leshchinski, *VC Funds Limited Horizon as a Source of Inefficiency*, 2005

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