Shadow Capital in Venture Financing: Selection, Valuation, and Exit Dynamic

Prof. Dr. and Na Dai, Douglas Cumming

University at Albany, the United States

Abstract

Non-venture capital private equity funds (PEs), such as growth and expansion funds, and buyout funds, have become increasingly interested in investing in entrepreneurial firms, which have traditionally been an investment territory of venture capital funds (VCs). We investigate how PEs invest and perform in this space, in comparison to VCs, and the implication of PEs' participation on entrepreneurial firms. Three interesting findings emerge. First, PEs are more likely to invest in entrepreneurial firms after their typical investment period and when there was substantial capital overhang. PEs often prefer the expansion and late-stage ventures. Moreover, PEs are more willing to invest in companies that are not located in the same state as the fund. Second, investment size and valuation are significantly larger/higher when PEs participate in an investment round. Interestingly, PEs are less likely to use debt when they invest in entrepreneurial firms. Third, regarding the exit strategy, we find that secondary buyout is more prevalent among companies with PE investments in comparison to those without. After controlling for the exit type, we further show that PEs' participation allows entrepreneurial firms more time to get ready for exit. Our results are robust in alternative specifications and after controlling for the potential endogeneity issue related to correlated omitted variables.

Keywords: Venture Capital, Private Equity, Capital Overhang, Valuation, Exit