Master Thesis Report on Literature Review of Venture Capital

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Abstract

The field of technology investing is ridden with dire risks, particularly the ones arising from the presence of asymmetric information among venture capital firms (VCs) and entrepreneurs. The objective of this study, is to assess the differential strategies devised by the high-technology focused foreign VCs and domestic VCs in negotiating the information risks encountered by them. In this study comprises 70 active VC firms – both foreign and domestic drawn from the Venture Intelligence database. Using the theoretical framework of resource-based view and transactions costs theory and the non-linear data mining technique of Classification and Regression Trees (CART), first segregate segments of foreign VCs and domestic VCs exhibiting the highest technology focus. Further, and profile each of these segments and compare and explain the differences in the risk management strategies pursued by them.

The results from this study bring to light several interesting findings. To start with, all high-tech focused foreign VCs are not uniform with regards of the risk-management strategies deployed by them. In general, foreign VCs rely on domain specialization, deep sector knowledge and geographic location as primary mechanisms of managing information risks. On the contrary, for high-tech focused domestic VCs syndicating with other specialized VCs combined with the opportunity recognition potential of their investment executives with erstwhile founding experience emerges as the core risk-control strategy.

Keywords: High-technology, Information asymmetry risks, Domestic VCs, Foreign VCs, Venture capital, Syndication

1. INTRODUCTION

Venture Capital Financing

This chapter provides an introduction of the topic by detailing the phenomenon of Venture Capital financing. In the first section, a general discussion has been provided about the role of Venture Capital financing in growth and development further details about the impacts of Venture Capital in various sectors of Pakistan's economy.

In the remainder of the chapter, the assessment of Venture Capital financing has been detailed in growth and development of Pakistani economy. Further the implications of this study endeavour to both study and practice shall be presented. The Venture Capital investments aids in the growth of innovative entrepreneurships in Pakistan.

Venture Capital has evolved as a result of the need to provide nonconventional, Risky finance to new ventures depending upon innovative entrepreneurship. Venture Capital is an investment in the form of equity, quasi-equity and sometimes Debt, straight or conditional, shaped in new or untried concepts, promoted by a technically or professionally abled entrepreneur.

It refers to capital investment, including equity or debt or both, which carries significant risk and uncertainty. The risk envisaged may be very high may be so high as to Result in total loss or very less so as to result in high gains Small businesses never seem to have enough money. Bankers and Suppliers, naturally, are important in financing small business growth through loans and credit, but an equally important source of long term.

Growth Capital is the Venture Capital firm. Venture Capital financing may have an extra bonus, for if a small firm has an adequate equity base; banks are more willing to extend credit. Venture Capital is money provided by professionals who invest alongside management in young, rapidly growing companies that have the potential to develop into significant economic contributors. Venture Capital is an important source of equity for start-up companies.

Venture Capital is capital typically provided by outside investors for financing of new growing or struggling businesses. Venture Capital investments generally are high risk investments but offer the potential for above average returns and/or a percentage of ownership of the company. A venture capitalist (VENTURE CAPITAL) is a person who makes such investments.

A Venture Capital fund is a pooled investment vehicle (often a partnership) that primarily invests the financial capital of third-party investors in enterprises that are too risky for the standard capital markets or bank loans. The term 'Venture Capital' is understood in many ways. In a narrow sense, it refers to, investment in new and tried enterprises that are lacking a stable record of growth.

In a broader sense, Venture Capital refers to the commitment of capital as shareholding, for the formulation and setting up of small firms specializing in new ideas or new technologies, is not merely an injection of funds into a new firm, it is a simultaneous input of skill needed to set up the firm, design its marketing strategy and organize and manage it. It is an association with successive stages of firm's development with distinctive types of financing appropriate to each stage of development.

According to International Finance Corporation (IFC), Venture Capital is equity or equity featured capital seeking investment in new ideas, new companies, new production, new process or new services that offer the potential of high returns on investments. As defined in Regulation 2 (m)of SEBI (Venture Capital Funds) Regulation , 1996 "Venture Capital fund means a fund established in the form of a company or trust which raises monies through loans, donations issue of securities or units as the case may be, and makes or proposes to make investments in accordance with these regulations. Thus Venture Capital is the capital invested in young, rapidly growing or changing companies that have the potential for high growth.

The VENTURE CAPITAL may also invest in a firm that is unable to raise finance through the conventional means. Professionally managed Venture Capital firms generally are private partnerships or closely- held corporations funded by private and public pension funds, endowment funds, foundations, corporations, wealthy individuals, foreign investors, and the venture capitalists themselves.

When considering an investment, venture capitalists carefully screen the technical and business merits of the proposed company. Venture capitalists only invest in a small percentage of the businesses they review and have a long-term perspective. Going forward they actively work with the company's management by contributing their experience and business savvy gained from helping other companies with similar growth challenges. Venture capitalists mitigate the risk of venture investing by developing a portfolio of young companies in a single venture fund.

Many times they will co-invest with other professional Venture Capital firms. In addition, many venture partnership will manage multiple funds simultaneously. For decades, venture capitalists have nurtured the growth of America's high technology and entrepreneurial communities resulting in significant job creation, economic growth and international competitiveness.

Companies such as Digital Equipment Corporation, Apple, Federal Express, Compaq, Sun Microsystems, Intel, Microsoft, Yahoo, Airtel and Genentech are famous examples of companies that received Venture Capital early in their development. Venture Capital is the business of establishing an investment fund in theorem of equity financing via investments in the common stocks, preferred stocks and convertible debentures of various companies.

These companies are seen to have a high growth potential and are able to be listed on the stock exchange in order to gain the highest returns in dividends and capital gain. In addition to the various studies on Venture Capital financing in the US, recent empirical study has analyzed the markets for Private Equity and Venture

Venture capitalists generally:

- Finance new and rapidly growing companies;
- Purchase equity securities;
- Assist in the development of new products or services;
- Add value to the company through active participation;
- Take higher risks with the expectation of higher rewards;
- Have a long-term orientation

Capital (VENTURE CAPITAL) in several established European countries.

The emerging literature refrains from transferring findings from the US VENTURE CAPITAL industry 1-1 (one to one) to Europe and pay's growing attention to the individual characteristics of VENTURE CAPITAL markets in different regions (Jeng and Wells, 2000). Nevertheless, the evidence on less developed markets with a blossoming need for growth capital has largely been neglected.

The lack of additional comprehensive studies analyzing the investment behavior of Venture Capitalists (VENTURE CAPITALs) in smaller markets calls for further study in this field. As Manigart et al. (2002) point out there is a wide range of economic, legal, institutional and cultural differences influencing the environment in which Venture Capital operate.

Thus, the miscellaneous and comprehensive conclusions drawn on the North American VENTURE CAPITAL market are not necessarily applicable to the European VENTURE CAPITAL industry as a whole. This paper aims at filling this gap by investigating the behavior of Venture Capital in Switzerland with respect to financing mechanisms employed and the extent to which collaboration between Venture Capital is used to cope with informational barriers.

It is the first of its kind which explicitly focus on the Swiss market and add to the growing empirical literature on staging and syndication in European countries. Regarding the role of VENTURE CAPITAL, you can assume that the use of a staged financial structure can be as important as the pure provision of capital. Overcoming the problem of incomplete information and monitoring the activities of portfolio firms can be valuable.

Thus, I analyzed to which extent Venture Capital investing in Switzerland make use of staged capital infusions. I start by documenting the driving forces of staging for Venture Capital operating in Switzerland. I realized that among the different affiliations of VENTURE CAPITAL in Switzerland especially independent investor's make more extensive use of stage financing.

Moreover, so the results suggest that staging is employed as a tool for mitigating risks. Firms that focuses more extensively on certain stages employ on average more financing rounds. Recent literature has shown that firms can join forces with other partners to combine resources and capabilities in order to overcome information asymmetries and get access to deal flow.

I investigate the reason behind the formation of such syndicates and estimate the effect that cooperation of financial institutions has on the value and prospects of the funded portfolio company. I find that foreign investor's make more extensive use of syndication efforts when investing in the Swiss market. Syndication allows the foreign investor's to spread their capital over a larger number of deals without diluting effort available to the other funded firms.

Moreover, syndication can serve as an entrance strategy to new markets. In addition, I find that Venture Capital which use staged capital infusions are more likely to be affected to join forces with partners. This is line with the argumentation of Fluck, Garrison and Myers (2005) suggesting that the syndication of VENTURE CAPITAL investments could alleviate agency problem between the VENTURE CAPITAL and the entrepreneur and consequently, Venture Capital that make use of staging should also be more open syndication.

The value of Venture Capital reputation.

Reputation is very important to the firm's growth and future performance. Reputation is based on a firm's outstanding history of actions and performance, it builds expectations about the firm's future performance (Rindova et al., 2005). If the firm has good reputation consumer willingness to pay will be high and also reduce stakeholders' uncertainties.

The consumers pay more for the products and services of high-reputation firms' good or high reputation also reduces the uncertainty of suppliers and partners so they offer more opportunities on favorable terms and conditions (Fombrun, 1996; Rindova et al., 2005). High-reputation Venture Capital can both decrease investor uncertainty and provide resources to young start-ups that develop their operating performance.

There many advantages to high reputation firm. The customer liking and willingness to do business with high reputation firms even other firms or companies are very good at their cost and quality. High reputation firm can charge a premium for product and services. Stakeholder supports the firm in time dispute and problem.

An international surveys revealed that more than half of an organization's reputation can be attributed to the CEO. The CEO of the company has the main role in creating the reputation of the firm. According to US research conducted in 2003 among 1,400 influential stakeholders, about 50% of a company's reputation could be associated to the CEO.

The German research which was conducted in 2001 revealed that CEO's reputation accounted for two-thirds of overall high reputation. Thus the CEO's reputation can potentially add millions of dollars to the market value of the company.

LITERATURE REVIEW

In order to make inferences on the staging and syndication behavior I make use of a data set on Venture Capital transactions in Pakistan.

The sample consists of Venture Capital transactions in Pakistan within the period 1989–2005, whereas the maximum deals undertaken is concentrated in the later years. The transactions have been compiled by using public sources and the Thomson Venture Economics (TVE) Database. I have identified the involved parties in each transaction and the corresponding information on the Venture Capital along with the funded firms, result is a deal survey exhibiting who has funded a new company and was joined by which partner. Moreover, I collected data about each financing round.

Hence, I can identify which Venture Capital shave made investments into a target firm at which point in time. Venture Capital. In order to give an idea about the distribution of investments over time and industries I used the information from TVE to identify the sector of a particular venture. Here I make use of the Venture Economic Industry Classification (VEIC) – a Venture Economics proprietary industry classification scheme.

And divided the Medical/Health classification in two separate categories. I created categories for Software and Internet firms to illustrate the importance of investments into “New Economy” firms over the period. In addition, I collected data and information about the different stages of development when an investment has been made.

TVE gives information about five different categories: Start Up/Seed, Early Stage, Expansion, Later Stage and Other. Similar to Gompers (1995) who label the categories for bridge, second and third stage financing as “Late Stage” financing, I accumulated the TVE categories Expansion, Later Stage and Other to form a new category, that I also label “Late Stage”.

As there is no clear distinction between Expansion financing, that almost always occur in later stages, and other financing activities, that namely concern bridge financing or special purpose financing, from the “Later Stage” category this combination appears to be the most reasonable classification scheme. The number of transactions increased until the year 2001 with a peak of 99 Venture Capital deals.

The years 2002–2004 have seen a steady level of investment activity of 30 transactions. With respect to the industries financed one can see that Internet firms have been attractive during the dot.com boom but have not been of interest to Venture Capital ever since.

The same effect can be found for Software firms that peaked during the years 1999 and 2000 and steadily declined to 6,5% of the total transactions undertaken in 2004 (from about 30% in 1999 and 24% in 2000). The relative importance of Biotech, Medical and Pharmaceutical firms has experienced a constant interest from the side of the Venture Capital over the late 90s and the importance has even increased with the ending of the dot.com boom in 1999/2000.

The number of deals in the “Old Economy” industries such as Industrial Products and Electronics has plunged in the late 90s but has gained significance over the recent years. It is also provides evidence about the distribution of financing events across stages of development. One can infer that the focus of the Venture Capital has been more on Later Stage financing until the year 1999.

Start Up and Seed financing remained on a relatively modest level and only gained significance with the beginning of the new millennium. This also emphasizes the relatively juvenile market Pakistan, where the initial investment steps concentrated on less risky late stage transactions. With the growing experience gained through investing, Venture Capital shifted their focus to earlier stages of the investment life cycle.

In the later years the investments have been made roughly equally in all stages of development. For the scope of the upcoming analysis I included the characteristics of the VENTURE CAPITAL to see how those factors impact the decision to stage an investment or make use of extensive partnering. I classify the companies as being an independent venture capitalist if there are no strings to other firms or banks attached.

Secondly, I classify Venture Capitals banking dependent when a private bank has founded them or a private bank holds more than 50% of the shares. Thirdly, I classify Venture Capital as public if the shares are hold by either a government or by a governmental public fund. Additionally, I included corporate Venture Capital when the fund has strings to a large corporation.

In order to control for locality effects I included a dummy variable equalling one when the venture capitalist has an office in Pakistan from which it operates and zero otherwise. This "Pak Office" dummy is used to estimate the impact that familiarity and proximity to the local market and it particularities. The theoretical study on venture finance has only been recently emerged.

Venture Capital is a type of private equity finance involving investment in unquoted companies with growth potential. It is generally medium to long term in nature and made in exchange for a stake in a company. The term Venture Capital is likely to be accepted as the generic term for business angels, mezzanine equity, institutional or any other similar investments in early stages of business. In summary, it is "a professionally managed pool of equity capital" (Hisrich and Peters, 1998).

According to Berlin (1998), venture capitalists take an active role in the management of the firm. They fund the new company and work in close collaboration with the stock market to take the firm public. Therefore they place emphasis on the support to the company. They offer start-ups the controls, they might be granted as well as the exit strategy available.

In all, they foster growth in companies through hands-on involvement in financing, management, and technical support. In most of the venture capitalists firm, the ventures take a very active role in the working of the firm. Burgyl (2000) described Venture Capital as the intermediary between institutional investor (such as pension funds, banks, insurance companies) and portfolio companies.

Investment screenings, negotiation, making agreements, controlling investments and assisting to management team are the most common functions of venture capital. Mason and Harrison (2000) stated that after bubble of internet hype got busted, most of the Venture Capital companies had started funding only at maturity level because they did not want to take any risk while funding the ventures.

Because these companies had invested heavily into venture so they had wanted only safer option while investing. Smith (2001) has explained about the Venture Capital firm that these companies had given valuable support in terms of product development, production, marketing and other areas of business function.

A Venture Capital firm had searched and had invested into those companies which were already study oriented and had shown a growth curve. Selection of venture by Venture Capital firm:

1. Production capacity and past performance
2. Production planning of the venture
3. Results of the last few years Lerner (2001) argued that Venture Capital had impacted on four factors: firms, economy, innovation and geographical regions.

Firms had benefited from additional capital that was necessarily required for study and development, meanwhile economy was growing because of more new jobs, and bigger value addition of new Venture Capital backed firms as well as particular industry was flourishing because of bigger investment. Amit, Glosten and Muller (1993) had suggested that venture capitalists should be regarded as financial intermediaries.

The basic aspect of financial intermediaries was to provide a link between the entrepreneur and investor. This work had been done by venture capitalists in particular as they had provided fund to the new ventures. Lerner (2001) contended that Venture Capital backed companies were more innovative than their counterparts.

And the last, but not the least geographical regions had benefitted because of growing investment in R&D due to closer relationship between science and business sectors. F.C.C. &

Koh W.T.H. (2002) argued that thoughtful policies and support of the Venture Capital industry could create the right climate for innovation and entrepreneurship, which in turn would pay dividends in terms of job and wealth creation. Ueda (2004) had offered an explanation for why venture capitalists and banks had coexisted in an economy.

The key trade-off between the two choices was that while venture capitals? evaluations of the project quality were more accurate, they had also used the threat of expropriation to extract rent from the entrepreneurs. The model had explained why projects financed by Venture Capital been less collateral, high growth, high risk, and high profitability, and why Venture Capital markets were more active in markets where intellectual property was better protected.

Wonglimpiyarat (2007) argued that Venture Capital had improved the nation's innovative capacity by making investments in early phase businesses that had offered both high potential and high risk. Engel and Keilbach (2007) have used firm data to examine the effect of Venture Capital financing on innovation behavior, specifically on the number of patent registrations at the German patent office.

According to Dapkus and Kriaucioniene (2008) “Study and developments in business were seen as a key tool for economy upgrade and national competitiveness achieved through the development of high value added”. Meanwhile venture capital; with the financing such ventures had triggered the development of particular industry and at the same time of the overall economy (Snieska Vytautas & Venckuviene Vitalija 2009).

Florida and Kenney (1988) contended that Venture Capitalin each region had boosted economical development by attracting entrepreneurs and technical personnel. Venture capitalists had not only helped to organize the process of innovation but also functioned to a large extent as technological „gatekeepers? for the United States? economy and its fastest growing regions (Florida & Kenney, 1988).

In the study conducted by Hart and Moore (1994) had been explained that the option of the entrepreneur to repudiate her financial obligations had limited the feasible amount of outsider claims. Neher (1994) had extended their approach to stage financing as an instrument to implement the optimal investment paths. Admati and Pfleiderer (1994) had shown that a fixed fraction equity contract might give robust optimal incentives if it was efficient to allocate the control right to the venture capitalist.

Bergdorf (1994) had considered convertible debt in a framework of incomplete contracts (holdup problem) to transfer control rights to the value-maximizing party. Chan, Siegel and Thakor (1990) had explained the optimal transition of control between entrepreneur and venture capitalist in a model with initial uncertainty about the skill of the entrepreneur.

Hellmann (1996) had explained the entrepreneur's willingness to relinquish control rights by a trade-off between equity and debt induced incentives. Trester (1997) had argued that the problem of an entrepreneur dissipating the firm's assets could be mitigated if the investor had no option to declare default and seize the assets. Cornelli and Yosha (1997) had analysed the problem of an entrepreneur, manipulating short-term results for purposes of "window-dressing".

Venture Capital funds are not the only financial intermediaries that bridge gap between the investors and small businesses; banks also provide the intermediary function for small businesses. Ueda (2004) had focused on the ex-ante screening ability differential between venture capitalists and banks. Winton and Yerramilli (2008) model followed-on financing decisions, thus incorporating ex-post (costly) monitoring into their analysis.

In addition to the standard continue-or-liquidate decision, the model allowed for an aggressive or a conservative continuation choice, which made continuation strategy risky in the sense of cash flow volatility between the two choices. Venture capitalists had better ability to monitor, but had demanded higher returns because they had imposed illiquidity on their investors; In contrast, banks were less skilled at monitoring, but had demanded lower returns from entrepreneurs because they themselves had faced lower funding cost by exposing themselves to liquidity shocks.

Venture capitalists were optimal only if firms had faced high risk and positively skewed project cash flows, with low probability of success, low liquidation value, and high returns if successful, and if they had faced highly volatile cash flows across two continuation strategies. The number of companies which venture capitalists had monitored seems to have changed little since 1984.

Metrick and Yasuda (2010) had reported that, for a sample of funds raised between 1993 and 2006, a mean (median) Venture Capital fund had invested in 24 (20) companies and had 5 (4) partners, suggesting that a partner at a typical Venture Capital firm running two funds on average would monitor close to 10 firms at a given point in time. Kaplan et al. (2009) had examined fifty Venture Capital backed companies that eventually went public, and had found that business lines remained stable from early business plan to IPOs, while management was frequently replaced. Therefore, the results had suggested that the business (idea) rather than the management team should be the key screening criteria for investments in start-ups.

The evidence of frequent management turnover was in line with Hellmann (1998), which had explained that in equilibrium, founders voluntarily had relinquished control of the firm so that venture capitalists had incentives to search for a superior management team without fear of holdup. In an empirical study of a large, comprehensive small business dataset, Puri and Zarutskie (2010) have found that Venture Capital backed companies had tended to be younger, faster-growing, and larger compared to non-Venture Capital backed companies.

Thus, scalability was an important criterion that venture capitalists used to screen prospective investments? market potential, while profitability was not. The tendency for faster growth of Venture Capital backed firms had also contributed to the higher CEOs turnover rate: rare are individuals who had the talent and skill sets of founder- CEOs of start-ups as well as those of professional managers running multi-billion dollar companies.

First, venture capitalists had intervened very actively in the management of the firms that they funded: they used their experience, contacts, and reputation in order to provide advice to the entrepreneurs, especially with regard to issues such as the selection of qualified personnel or the dealing with suppliers and customers. Second, the infusion of capital had occurred in stages, matching investment decisions based on information that had arrived over time.

Third, it had relied on equity-like and convertible securities instead of the senior secured debt that characterized most bank finance. (Chan 1983) had done his study about Venture Capital investment and had found that imperfect information about investment and ill-informed entrepreneur did not make wise decision to make investment and in this way they had earned low return.

While, if they had proper information about investment into new ideas and new ventures, they could earn huge amount. (Campello and Da Matta 2010) had made an equilibrium analysis about limited partners? demand and services of the general partners, quality of general partners and their investment patterns in Venture Capital fund.

They had evolved that except venture capitalist, there were large number of financial intermediaries who had worked as an active agent such as bank and these intermediaries had bridged the gap between investors and small businesses. These banks had worked for both Venture Capital and small businesses as well. Veda (2004) has explained why venture capitalist and banks had equal importance in an economy.

This model has explained that Venture Capital financing has been less collateral, given higher growth, higher risk and higher profitability and why venture capitalist market was more active and provided better protection for intellectual property. Winton and Yerramilli (2008) have presented a paper and in this paper, they had compared Venture Capital financing and bank financing.

While Veda (2004) mainly focused on screening abilities of bank and Venture Capital funding, Winton and Yeramilli (2008) have mainly focused on financing decision so they could analyzed about post financing scenario as well. When they had seen notability into these two choices, Venture Capital companies were having better techniques and mechanism to monitor financing but they had wanted better returns because they had been pressured from their investors.

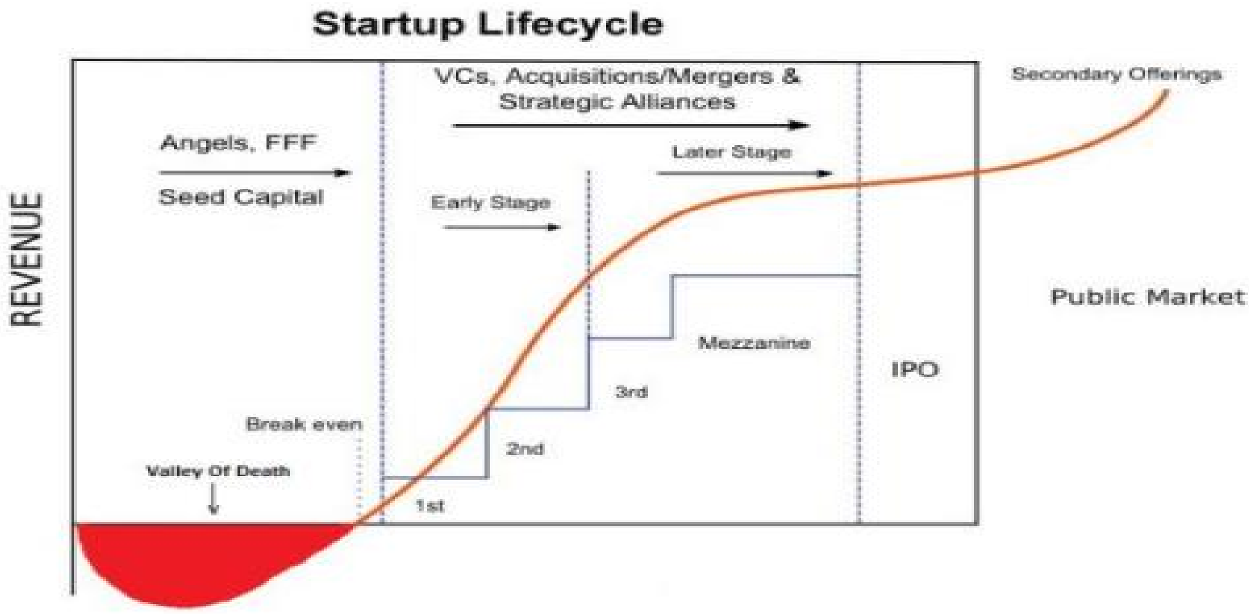
But on the other hand, bank had lower monitoring rate because they had wanted lower returns from entrepreneurs. Bank had low cost of funding or fund raising activities. Venture Capital firm might opt for high risk but they had needed high margin because their main objective was to earn better returns on their investments.

Startup life cycle at different stages.

Venture capital at Early stages or later stages?

Business angel investors or Angels are highly net worth individuals who usually provide smaller amounts of finance e.g twenty five thousand to fifty thousand euro (€25,000 to €500,000) done **at an early stage** in the form of equity investments rather than debt investments. The usual profile of an Angels is that of a serial entrepreneur's who has exited from their own ventures and now invests in the next generation of founders. Angels usually contribute more than pure cash rather than debt. they are industrialist and have industry knowledge and contacts that they can pass on to the entrepreneurs, irrespective of experience in starting and growing a company. Angels will usually take non-executive board positions in the companies in which they invest and act as advisors to the start up team and have a check on it how the company or firms is growing or not.

An Angels investment is normally a small amount of investment usually 10 to 30% and it is directed at the pre-seed, seed or early stage and startup phase. They are continuously investing in angel syndicates and alongside seed venture capital funds. Correspondingly, venture capitalists mainly make in the later stage minority investments (venture investments) or expansion majority investments (buy-outs):



Angels has dual advantage provide both financing and managerial experience, which increase the likelihood of startup enterprises to survive the "valley of death". Statistics shows that ventures funded by angel investors has to be proven more successful than those which have been rejected, as a result by their survival rates and the evolution of their employment (Kerr et al., 2011). Given the importance of early stage investors like Angels for the creation and maintenance of an entrepreneurial economy, encouraging their investment has a significant leverage effect on job and wealth creation.

Business Angels play an important role in the economy, and in many countries, constitute the main source of external funding, after family and friends, in newly established ventures. They are increasingly important by providing risk capital as well as contributing to economic growth and technological advances. Moreover, the supply of startup and early stage equity finance has to some extent become more dependent on business Angels, as venture capitalists are not able to accommodate a large number of small deals. The traditional source of startup and early stage financing – bank lending – is limited due to risk level of high fixed interest rate and handling cost.

Angels are currently the rising movement, presently in every single European country, and EBAN keeps on working to advance their development in all countries.

2.1 The Economic Rational for Professional Buyout Investors

Professional buyout investors' literature had always focused on public to private deals.

But before public listed companies were purchased and delisted by buyout investors. In the literature review below, there are two aspects. In first aspect conflict between shareholders and managers are discussed and leveraged buyouts are proposed as a solution and in another solution liquidity is emphasized as main point for the firm going to privates. Jensen and Meckling (1976) and Jensen (1986, 1989, 2007) had developed a hypothesis and implied about free cash flow.

They had shown that free cash flow public firm always had created an agency problem and leveraged buyout had solved these problems between shareholders and managers. A public firm manager could misuse the firm's free cash flow for their own self-interest and shareholders were not satisfied because of these strategies. Leveraged buyouts were the good tools because of high debt agency. Managers had the responsibility to spare the debt as early as possible.

These types of firms did better and had shown better financial results without any problem. Lehn and Poulsen (1983) have studied the sample of 263 private transactions between 1980 and 1987 and have got empirical results for Jansen's free-cash-flow hypothesis. Cash flows which were not distributed were the main factors for the firm to go private and stake holders to get their due premium out of this undistributed cash flow.

Mehran and Peristians (2010) conducted a study about the companies which had become private between 1990 and 2007 and had argued that main reason of the companies to go private was their failure to attract investor's interest. Firms which were having low stock turnover, they would prefer to go public as early as possible. Bharath and Ditmar (2010) had also got the similar results; they had studied a sample of the firms which went private from 1980 to 2004.

Both studies compared the firms, taken over by BO fund and acquired by other investors. They found that they had become private for the same reason. If firm had higher free cash flow it was likely that firm would be non-LBO going.

2.2 Economic Rational of Private to Private buyouts

All the largest buyout which was taking place in the entire business world, they were private to private buyouts.

Stomberg (2007) had conducted a study and he had taken sample of 21,397 buyouts transactions between 1970 and 2007. In these buyouts 97 per cent were private to private buyouts. Ching (2009) had studied and had told that these buyouts had always been worked for better and had gone into fruitful and successful results.

Unlike most other financial intermediaries, such as pension funds and banks, venture capitalists were active investors. They had many mechanisms to mitigate these principal-agent conflicts suggested by Jensen and Meckling (1976). First, venture capitalists had engaged in a screening process (Chan 1983). They had carefully screened projects and firms with great potential to succeed.

They had collected information before deciding whether to invest and had tried to identify ex-ante, unprofitable projects and bad entrepreneurs (Kaplan and Stromberg 2004). They had carried out formal studies of the technology and market strategy, and informal assessments of the management team. Second, venture capitalists could design financial contracts to reduce investment risks, for example, convertible securities, allocation of control right and cash flows (Berglof 1994, Hellmann 1998, Hellmann 2001, Cornelli and Yosha 2003, Kaplan and Stromberg 2003, Schmidt 2003).

Sahlman (1990) had suggested that three control mechanisms were common to nearly all Venture Capital financing: the use of convertible securities (Trester 1998), syndication of investment (Lerner 1994b), and the staging of capital infusions (Gompers 1995). Kaplan and Stromberg (2003) had shown how venture capitalists had allocated various control and ownership rights contingent on observable measure of financial and non-financial performance.

After studying 213 investments in 119 portfolio companies by 14 Venture Capital firms, they found that if a portfolio company had performed poorly, venture capitalists would obtain full control. As the performance would improve, the entrepreneurs again would obtain more control rights over the company.

2.3 What Venture Capitalist and buyouts Investors do

Private equity investors are very active because they work on behalf of their limited partners. These limited partners give money to the Venture Capital firm and Venture Capital firm further invest money into an idea or new venture with a view to get good returns. Now the literature is focusing on three main activities of Venture Capital firm:

1. Pre-investment screening activities
2. Monitoring while holding period
3. Activities which are associated with the existing process.

2.4 Venture capitalist and their economic activities

Venture capitalist firm works as a general partner. These firms get fund only for a finite period of time. Generally, this time period is ten years. A firm generally raises fund after every three to five years and invest into more than one venture, which it manages consecutively two funds at a time.

If fund is invested for five years or less than five years, general partner has to work very hard and invest more time, energy and effort to manage the fund. General partners have to screen a number of prospective start ups before investing its fund into it. Funds which are invested for more than five years, they are called growth and harvesting stage fund and for these fund venture capitalist has to just monitor the fund and in this stage Venture Capital fund companies assist the portfolio companies. And at last they help the companies for exiting.

In this process, initial public offer and acquisition techniques is sought. When Venture Capital firm sees that venture is not going to give any profitable results, they shut down the business in that non-profitable business. Gooman and Sahlman (1989) had conducted a study regarding the process of Venture Capital companies. They had taken a sample of hundred Venture Capital firms in 1984.

They had concluded how a Venture Capital firm had invested its time into various operations. They had got the following results:

a) Venture Capital firms had spent their half time in monitoring their investment in the nine portfolio companies.

b) They had sat on the board of the companies and its numbers were five.

c) As board member, they had spent so many hours with the companies and on telephone; they had spent thirty hours, while they were having contact with companies.

d) They were engaged in fund raising analysis and recruitment of the management staff. Metrick and yasunda (2010) had conducted a study and for this study, they had collected some sample for fund raised between 1993 and 2006.

This study had shown that each Venture Capital firm was managing ten companies at a given period of time. Kaplan (2009) had examined fifty Venture Capital backed companies and had found that their business had started quietly from early stages to initial public offer, while management had seen a lot of changes. This result had depicted that business idea was more important rather than management.

While screening, the startup idea had shown to be the main criteria rather than quality of management. Hellmann (1998) had conducted a study and found that equal-partners had left the companies and Venture Capital firms were having fair chances to search for better management.

Puri and Zarat skie (2010) had done an empirical study and found that Venture Capital backed companies were fast growing and larger as compared to non-Venture Capital backed companies. So scalability was the main point while selecting a company for investment. Profitability was not the main criteria. Faster growth of the companies had seen changes in the number of CEOs. There are few chances that CEOs continue for a long time.

2.5 Do Venture Capital companies make funding in high-growth companies or those companies which are funded by Venture Capital companies grow fast?

Facing with valuation uncertainty, Sahlman (1990) had suggested that the coping mechanism was to either design investment contracts which materially would skew the distribution of the payoffs from the project to the Venture Capital investors or would include the active participation of the Venture Capital investors to assure that the project had the professional managerial expertise to succeed.

Sahlman (1990) had identified the three key factors of the investment contract that skewed payoffs in favor of the Venture Capital investor: (1) the staging of the commitment of capital, (2) the use of convertible securities instead of straight common shares and the associated senior claims on the assets of the firm in case of failure and (3) anti-dilution provisions to secure the Venture Capitalinvestors equity position in the new firm.

Of these mechanisms, he had concluded that staged capital infusions were the most important control mechanism that a venture capitalist could employ. Cossin, Leleux & Saliasi (2002) had examined the economic value of these legal features in a real option context.

Inderst and Muller (2009) had conducted a study which had concluded that both the conditions might be applicable.

Their paper had shown if a Venture was financed by a Venture Capital firm, this venture would take the advantage of this funding. The products of this venture might take lead on its rivals because over-investing had always supported these types of products. Their paper had shown that Venture Capital firm was very useful for emerging market because it would encourage higher growth and large scale.

Venture Capital firm had made target of this type of ideas and would put its hard effort to make these ideas successful and that was in a very short period of time. They had found that how Venture Capital fund monitored and made investment. This monitoring was stage wise. Funding was also conditional. Some payment was made in advance and rest of the payment was made phase wise and according to the performance of the venture.

If Venture Capital firm had seen that venture was not going according to the terms and conditions specified in the agreement, they had abandoned the project in the mid way. Gompers (1995) analyzed Venture Capital funded companies. He had taken a sample of seven hundred and thirty-four companies. He found that a firm which had higher cost in performing the various task, was being monitored frequently.

Venture Capital companies had given active advice to run the company and had told them how to manage the staff. Hellmann and Puri (2002) conducted a study and found that Venture Capital backed companies had more professionalism. They had good human resource policies and had better marketing strategies. They had used a sample of European Venture Capital deals.

Bottazzi (2008) found that those Venture Capital companies which had more experience had helped their portfolio companies for better management and fund raising activities. They had helped the portfolio companies for recruiting the staff for running the entire show. Both Baker and Gompers (2003) and Hochberg (2003) conducted a study and found that Venture Capitalcompanies made a change in the board of directors.

Boards of directors of these companies were more independent. Lerner (1995) found that Venture Capital backed companies had witnessed more turnover rate in CEOs of the companies and those companies which were not backed by venture capital, they had stake CEOs.

Cornell (2010) had made a survey for European Venture Capital investment data and found that after IPO, those companies which were backed by Venture Capital companies, showed low earning rate and those companies which were not supported by Venture Capital firm showed better results. Kortum and Lerner (2000) had made a study about the Venture Capital companies and their patenting strategies.

They found that Venture Capital companies? patents were more valuable. Hellman and puri (2000) found that Venture Capital companies had taken less time to bring product into the market and especially those products which were innovative and new to the market.

This had shown that a Venture Capital firm invested into innovative ideas and even when a Venture Capital firm exiting from the venture, this innovative process continuous. Sometimes a Venture Capital firm and its portfolio companies compete with each other. Lindsey (2008) had made a study and found that those companies which were having the same Venture Capital company as their financing partner, were having better strategic alliance.

2.6 Economic activities of buyout investors

Both Venture Capital and buyout fund which were making investments in ventures, these investments were illiquid. The final returns for Venture Capital companies were reported as internal rate of return.

2.7 Deal-level performance: Venture Capital

Brave and Gompers (1997) had conducted a study about Venture Capital backed companies and non-Venture Capital backed companies. They had studied the data between 1972 and 1992 and found the Venture Capital backed companies‟ initial public offers were better than non-Venture Capital backed companies. They found that the Venture Capital backed companies were never formed under pressure. They found that the reason of better performance was that ventures always had a pressure from the Venture Capital companies to perform.

Cochrane (2005) had used mean, standard deviation and beta of venture companies to measures the risk and return with the help of vitality. He found these measures with respect to and calculated volatility and concluded how a Venture Capital firm might invest into a venture where investment was not risky and return was also higher. Sorensen (2010) had developed a model which studied that beta value should be between two to three. This had clearly shown that individual security of the company was highly volatile as compared to stock exchange where this security was listed.

2.8 Performance Persistence and Sources of Performance

Kaplan and Schoar (2005) had conducted a study and found that Venture Capital was more persistence than BO. BO fund managers increased the size of fund, when they increased in numbers. But a Venture Capital fund manager did not increase the size of fund. When talking about making investment by venture capital, following points were reviewed:

2.8.1 Industry

This was the main point when Venture Capital firm had invested into a company. Generally Venture Capital companies had wanted those companies which could provide better results. A venture capital, as name suggests try to invest where more risk is involved with innovative ideas and more return as compare to investment into other types of companies. Amit, James and Zott (1998) had conducted a study and they found that a Venture Capital firm should be vigilant and should make a place into a segment so that people could know more about the performance of the company. In their study, they had found the securities/companies in which Venture Capital firm had invested the money. They had to spend less money on the monitoring point. So they had preferred companies like biotechnology, computer, and software etc. They had not preferred the companies like retail sector or fast food or food chains because these companies had required more monitoring and more cost was involved in these types of businesses.

2.8.2 Syndication

Bygrane, (1987); Brander et al (1999), had conducted a study about syndication. They had collected total sample of five hundred companies and had found that syndication add value to the portfolio companies because companies had required large fund to connect the innovative ideas into reality. Only one Venture Capital firm was not sufficient to finance the project alone, there was the need of other Venture Capital firms too with similar interest to come together and to construct syndication, so that large funding could be done for the ongoing project and each stage must have sufficient fund to invest. There should be smooth conduct of the activities. Chemmanor and Tian (2009) had also conducted a study and had found that syndication was always better than a single Venture Capital company because at the time of exit, syndication did better than as individual firm. Those companies which were successful in syndication, they had further made a prowl of companies and they had invested the money into the future projects. Wilson (1968) had conducted a study and had found that decision making process by a group of companies (Syndication), had delayed a process rather than investing by the single Venture Capital firm, even though decision making was done jointly to give better result as compared to single company.

2.8.3 Investment Duration

Cunnin and Macintosh (2001) had conducted a study about Venture Capital companies to find that investment into various stages was very important because it could give investors a very clear picture about the duration of the investment and its success rate. They had also collected data to find out the stage in which a project was funded by the Venture Capital and to know the duration of the investment.

Cumming and Johan (2010) had developed a theory of Venture Capital investment duration and had found that total duration of the investment was based on the marginal benefit which should be less than the expected cost for managing the portfolio.

2.8.4 Staging

Sahlman (1990) had conducted a study for staging decision. He had found that these decisions had played an important role while making the investment decisions.

2.8.5 Exits

Wang and Sim (2001) had conducted a study for the data between 1990 and 1998. They had found that family owned and high technology industries would exit generally through initial public offer. This initial public offer would be depended on total amount financed by the Venture Capital firm and total sale of the company.

Giot and Schwiebacher (2007) had conducted a study around six thousand Venture Capital backed firm, covering around twenty thousand rounds. They had found that with the passing of great time, there were many changes in companies‟ existing policy via initial public offer.

Bienz and Leite (2008) had conducted a study and had found that those companies which had made good profit, they would have opt for going public through initial public offer. On the other hand, those companies which had earned less profit, they would have gone for trade sales. They had also found that if product was more innovative, going public would be more profitable as compared to trade sales. Arif and Abdul khadir (2005) had conducted a study and had found that those firm which had low investment, they would have exited through initial public offer. Initial public offer route is also related to total amount which is financed by Venture Capital firm, total rounds done by Venture Capital companies and total funds which have participated in the whole process.

2.8.6 Dot-Com effect

M.B. Green (2004) had conducted a study for pre-bubble, bubble and post-bubble period and he had analysed the investment patterns for stage financing of various industries.

2.9 Pakistani Venture Capital and Private Equity Industry

Prof. I.M. Pandey had conducted a study in the year 1998. This study was based on the process of developing Venture Capital in Pakistani from the in-depth case study of the Technology Development and Information Company of Pakistani (TDICI). Initially TDICI had focused on high-tech industries but after that they had shifted to more profitable industries.
A. Thillai Rajan (2010) had conducted a study on the efficiency of Venture Capital and its portfolio companies. He had collected a sample between the year 2004 and 2008. He had found that in round I, there were larger investment and later on, it had decreased dramatically. Mostly these investments were in later stage and with short duration. He had concluded that these factors had not focused on good growth of Venture Capital industry in Pakistani.

Ljungquist and Richardson (2003) had conducted a study and had made an analysis of Venture Capital returns based on the cash flows of the ventures and buyout capital funds. Their study was mainly emphasized on timing and magnitude of decisions. They had calculated the time period in which capital was returned to the investors and for the overall functions of the venture capital.

They had also found that most of the firms had taken three years to invest 56.9 per cent and six years to invest 90.5 per cent of the total capital agreed to invest. These companies had taken eight years to convert internal rate of return into positive and ten years to exceed public equity returns. Further, they had found that the private equity was much better than public equity return. This return was five per cent to eight per cent higher in public equity. Under syndication, internal rate of return was higher than return in single company. They had produced good results when legal environment was in better situation. Weidig and Mathoned (2004) had conducted a study on the risk and return pattern of the various investment alternatives. They had calculated the risk-return of the various private equity investment alternatives such as direct investment. They had studied that calculation of risk was volatile in the market price as compared to various investment vehicles which had majorly impacted adversely because of lack of efficient market for price and product. Therefore risk was measured only in standard deviation with the help of average return. The return was measured as internal rate of return. This study had clearly shown that diversification had played an important role for direct investment and for various other funds. They had also found that around thirty per cent of the diversification was complete failure and investors had lost their capital.

Katz (2005) analyzed how Venture Capital backed and non-Venture Capital backed companies were affected in their performances and returns before and after initial public offers. In other words, he had tried to know that strong monitoring system would affect the earning of the management and performance after initial public offers as compared to non-Venture Capital backed companies. They had found that Venture Capital backed companies had performed better and had given better return as compared to management owned companies. If the size of the Venture Capital invested was large, in that case the financial performance of the companies after initial public offer would be better as compared to small investment by the Venture Capital firms. Some studies have also emphasized that economy of scale played an important role. Metric and Yasuda (2008) conducted a study and they had reached on the conclusion that a manager who had managed venture capital, his skills would be better suited to small firm and a manager who had managed buyout fund, his skills would be better suited to large firms. When a large firm with investment of US$ 1000 million was managed by a manager efficiently, if he had to manage a firm of US$ 10 million, he could do it quite successfully because he had earlier some experience. So we can say that buyout firm can be managed by one person in two different situations. But on the other hand, when we talk about a Venture Capital firm, a manager who is handing the company, when it is in is start-up stage, he can do it successfully. When this company matures, it is difficult for the same person to handle the entire affairs. So a Venture Capitalneeds another person to manage the company in more advanced stage. This is the basic difference while managing a buyout firm and Venture Capitalfirm. It is difficult to manage a Venture Capitalbacked firm as compared to buyout firm.

Cumming and Johan had conducted a study in 2007 about the rules and regulatory environment how a private equity firm did, when there was a perfect regulatory environment. When there was a scarcity of regulatory environment how these companies were affected. They had found that when there were low discloser standards for the companies, in that case, the cost for screening, governance and monitoring was increased because a venture firm did not have much information from the regulatory environment and sources. These firms had to evolve its own sources to collect the various type of information for its new venture because without screening it would be difficult to fund the new venture. After funding, proper governance and monitoring was required. But this process had increased the entire cost of the Venture Capitalfirm. So these companies were very particular, when they had wanted to invest into the venture as private equity. This study had shown that private equity would attract less investment. Again this study had shown that these companies had invested into the various companies not as a private equity but by other various means to avoid these rules and regulations. Cumming and Walz (2007) also had done analysis of the Venture Capitalfirms and found that there were number of drivers for institutional investment in private equity. They had found that institutional investment had preferred to invest in those private equity firms, where there was a lot of disclosure of the standards. Venture capitalists are one important category of investors that specializes in financing innovation (Amit, Brander, & Zott, 1998). The structure of Venture Capital arrangements had allowed these organizations to overcome many of the information asymmetry problems that plague external financing of the innovation. Thus, it is to be proposed that access to venture capital, which varies across environments and over time, makes new firms more innovative. As far as Pakistani is concerned, Chokshi had conducted a study in 2007. He had analysed the various factors which were responsible for stopping the process of leveraged buyout in Pakistani. These factors were: there were a lot of restrictions of the foreign investment in Pakistani, limited availability of professional management, under development of debt market, lot of restrictions of the bank lending. From the above restriction, it is clear that there were a lot of difficulties in investing into Pakistani corporate market. Banga Rashmi (2006) had done a study on the growth of service sector in an atmosphere where this sector had helped in removing poverty and unemployment. Due to growth of service sector, a huge opportunity in job marked was created. So a lot of unemployed person got the job and this led to remove the poverty from Pakistani. So we can say that growth in service sector had improved the overall economy of Pakistani. In this paper author had described about innovative investment means searching new avenues for investment. Dr. Alok Agarwal (2006) had done a study on venture capital. He had compared summer of Pakistani with venture capital, means it was very hot. Nirvikar Singh (2006) had also conducted a study about rapid growth of service sector. He had emphasized that this sector had large potential for growth. If we had paid attention on this sector, Pakistani economy would increase rapidly. He had also told that service sector should be industrialized. Industrialized means government should bring clear cut policy for this sector and make a conducive atmosphere for the development of this sector.

Mani Sunil (2006) had done a study about service sector and manufacturing sector. He had explained the role of government of Pakistani and its policy for Venture Capitalinvestment in Pakistani. This study had shown that chemical and pharmaceutics industry had attracted Venture CapitaLand capital was invested into study and development activities in this sector. This sector had created a number of patents. This process was responsible for the growth of service sector based on manufacturing sector. D. Nagayya (2005) conducted a study about Venture CapitaLand found how the development of this capital had impacted the growth of Pakistani economy. He had talked about pattern of Venture Capital fund and how it had grown. He explained that Venture Capital had developed in phased manner and after 1991, liberalization took place in Pakistani. Number of foreign companies came to Pakistani and set up their business. It had spurred the growth of Pakistani economy. As these companies came to Pakistani, they brought new ideas. When these new ideas were converted into reality, it needed a large amount of fund and thus this process had created a large pot of Venture Capital fund in Pakistani start-ups.

B. Bowonder and Sunil Mani had conducted a study in 2003 and they explained how innovation was responsible for the growth of Venture Capital in Pakistani. As the new ideas were innovated, it needed a large fund to convert this idea into reality. This study explained that government of Pakistani had supported these schemes. Mainly these scheme were responsible for innovative IT and IT enabled services, government of Pakistani formulated various conducive policies for the development of this sector. This led to smooth flow of Venture Capital into Pakistani. The innovative ideas had attracted a number of Venture Capital companies to invest in Pakistani. Jim Gordon and Poonam Gupta (2002) had done a study which was mainly pointing towards the growth of service sector and its impact on GDP growth. This study clearly showed that in the nineties, there was growth in GDP, due to a very fast growth in communication sector, development of the financial sector and growth of information technology sector. The main reason for the development of the GDP was because of development into the Venture Capital sector. More and more Venture Capital companies came forward and invested heavily into Pakistani start-ups. Dossani and Martin (2001) had conducted a study work for the development of Venture Capital firm in Pakistani. They emphasized on various patterns which were responsible for the growth or failure of the Venture Capital investment in many countries. These patterns were taken as a model in Pakistani. These models were implemented in Pakistan. Independence of the board and/or audit committee is negatively associated with earnings management and the likelihood of financial statement restatement.

Insider selling is positively associated with opportunistic behaviour in financial disclosure such as earnings management and accounting fraud. There is mixed evidence on whether earnings management is used before insider trading or after insider trading. Share distribution can exempt Venture Capital from securities regulation on insider trading, which makes the exit of Venture Capital out of the notice to other investors.

There are positive discretionary accruals (a proxy for earnings management) in the IPO year. Venture Capital backing is significantly associated with lower discretionary accruals in the IPO year.

There are a lot of restrictions of the foreign investment in Pakistan, limited availability of professional management, under development of debt market, lot of restrictions of the bank lending. From the above restriction, it is clear that there are a lot of difficulties in investing into Pakistani corporate market.

Summary & Conclusion

The literature review discussed above yields summarized findings as following:

1. Venture capitalists play an active role in corporate governance of their portfolio firms, by designing contract to allocate control rights, influencing the board of directors, and monitoring managers directly.
2. They emphasize various patterns which are responsible for the growth or failure of the Venture Capitals investment in many countries. These patterns are taken as a model in Pakistan. These models were implemented in Pakistan.
3. Venture capitalists carefully structure exit strategies for their investments. They normally do not sell any shares during the IPO, but they divest their interests in a portfolio firm within several years following the IPO.

In this study, is examine the hypothesis that venture capitalists play a role beyond the traditional roles of financial intermediaries. We provide evidence for the role of venture capital in the professionalization of start-up companies. Obtaining venture capital is related to a variety of organizational milestones, such as the formulation of human resource policies, the adoption of stock option plans, or the hiring of a VP of sales and marketing. Firms with venture capital are also more likely and faster to replace the founder with an outsider in the position of the CEO. Interestingly, however, founders often remain with the company, even after the CEO transition. The effect of venture capital is also particularly pronounced in the early stages of a company's development. The study is of interest to the growing literature on the theory of firm, providing evidence on a question that has received surprisingly little attention so far, namely the process by which resources are put together into a new firm. The paper contributes to the large literature on corporate governance, which has tended to focus on large, public companies. In contrast, our analysis shows that the effect of venture capitalists in corporate governance is important particularly when companies are still private. And the paper speaks to the large literature on the role of financial intermediaries. This literature generally documents that financial intermediaries play a monitoring role, gathering information about individual firms. This paper, as well as complementary work by Hellmann and Pure 2000! and

Kaplan and Stromberg 2000a, 2000, 2001, suggests that at least in the context of venture capital, investors can play a much larger role. The fundamental insight that there is more to venture capital than money and monitoring suggests some new research direction. On a theoretical level, we need to recognize that investors may gather information not merely *about* firms, but also *for* firms. When modeling financial intermediaries, it is important to capture these support functions wherein venture capitalists exert costly effort to give inputs, which increase the value of the firm. On the empirical side, this line of research raises a number of interesting questions. To what extent do other financial intermediaries, especially banks, provide similar support functions? And to what extent does this depend on the economic environment e.g., whether banks can or cannot hold equity!? This paper hopes to provide a starting point for further theoretical and empirical research on these important questions.

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