VENTURE CAPITALISTS, INVESTMENT APPRAISAL AND ACCOUNTING INFORMATION: A COMPARATIVE STUDY OF THE US, UK, FRANCE, BELGIUM AND HOLLAND

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Abstract

The differences between the information used for the pre-investment valuation and the valuation methods used by venture capital investors in five countries (US, UK, France, Belgium and Holland) are empirically studied. The analysis is based on postal questionnaire surveys of representative samples of senior venture capitalists in each country. Differences are found, which may be attributed to the dominant corporate governance mechanism or the level of development of the venture capital market. Between-country differences persist even after taking into account between-country differences in the relative importance of investment stages and venture capital types. Apparently similar systems and venture capital markets place varying emphases on different valuation methods, with theoretically 'correct' methods not always being preferred in practice. The findings of the study highlight the need for venture capital firms entering non-domestic markets to invest considerable effort in understanding the operation of these markets if they are to exploit fully their perceived competitive advantages and minimize the likelihood of repeating the problems experienced by venture capital entrants into foreign markets in the late 1980s.

Keywords: venture capital; investment appraisal; accounting information; corporate governance

J.E.L. classification: G24 Investment banks and venture capitalists; G34 Corporate Governance

INTRODUCTION

The venture capital (VC) industry is increasingly becoming more international, in terms of both funds raised and invested. A recent survey of senior venture capitalists carried out for the British Venture Capital Association, for example, showed that senior executives identified Continental Europe as a major market for new deal opportunities going in to the millennium (Wright and Robbie, 1996b). The European Venture Capital Association (1998, p. 93) reports that throughout Europe transnational investments are increasing, both proportionally and in absolute numbers. Whereas in 1993 about 10% was invested outside the home country of the venture capital company (VCC), this percentage increased to nearly 20% in 1997. This implies that 4.8 million ECU was invested in non-domestic ventures in the period 1992-1997.

This evolution in cross-border activity, combined with growing evidence of apparent varying returns on venture capital investments between the UK, France and Holland (BVCA, 1998; AFIC, 1997; NVP, 1998), has important implications for VCists and entrepreneurs. One of the crucial distinctions between venture capital and quoted equity is the prevalence of asymmetric information in the former (Wright and Robbie, 1998). It is not obvious that VCists in different countries use the same methods of working in their attempts to deal with asymmetric information problems. Bearing in mind the experiences of some of the cross-border entrants into Continental Europe in the late 1980s who subsequently exited non-domestic markets, an appreciation of these differences may help venture capital executives avoid a repetition of earlier problems.

Differences in the institutional, legal and cultural environment and in dominant corporate governance systems (Hofstede, 1984; Hampden-Turner and Trompenaars, 1993) may significantly influence the conduct of business. In respect of the VC and related industries previous studies have highlighted the heterogeneity of such markets across differing countries (Wright, et al., 1992; Manigart, 1994; Sapienza, et al., 1996). In the light of such general evidence, differences may also be expected in the approaches to the valuation of VC projects as well as the information used in the screening process. These aspects of the decision-making process can have a major impact both on the decision to invest in a transaction and the terms under which an investment is made, with clear implications for the eventual rate of return that is earned.

A number of studies have now examined the approaches to and information used by UK investment analysts in appraising the shares of companies quoted on a stock market (Arnold and Moizer, 1984; Moizer and Arnold, 1984; Day, 1986; Pike, Meerjanssen and Chadwick, 1993). Evidence is also emerging of the contrasting approaches used by VCists to appraise investments in unquoted firms (Wright and Robbie, 1996a ; Manigart et al., 1997). However, there is very limited evidence which compares approaches in different countries, an exception being the cross-country study of investment analysts covering the UK and Germany by Pike et al. (1993).

This study seeks to contribute to filling this research gap, at least in part, by examining the activities of VCists in relation to the appraisal of investment opportunities in unquoted firms in five different countries - the US, UK, France, Belgium and Holland - selected on the basis that their VC markets were sufficiently developed to permit meaningful quantitative surveys and afforded comparisons between different type of regime.

It seems likely that VCCs will select between a number of potential investee countries rather than focusing straight away on one country; the crucial issue is then the need to identify major cross-country differences which may influence this decision. The paper attempts to contribute to this decision-making process by focusing on providing evidence relating to the general policies adopted by VCists in each country in terms of approaches to valuation. The types of accounting and non-accounting information utilised in arriving at valuations, as well as the valuation methods, are analysed. It is recognised that the issues considered here are only a subset of the whole operation of a venture capital market, but analysis of all aspects would be beyond the scope of a single paper; our focus is on aspects which have hitherto been neglected.

The results of the study show that it is not possible to generalise from US or UK evidence to other countries. There are important between-country differences with respect to the valuation approaches of venture capital investment and the relative importance placed upon accounting and financial information in this process. The findings of the study highlight the need for venture capital firms entering non-domestic markets to invest considerable effort in understanding the operation of these markets if they are to exploit fully their perceived competitive advantages.

The paper is structured as follows. The following section discusses the issues concerning the valuation of VC investment decisions and the importance of accounting and financial information in relation to the countries examined in the paper. The third section describes the data and methodology utilised in the study and the fourth section presents the results. The final section discusses the implications of the results and suggests some conclusions.

COMPARISONS BETWEEN THE VENTURE CAPITAL MARKETS IN THE FIVE COUNTRIES

There is now extensive evidence to show that the general behaviour of VCists in the varying stages of the venture capital investment process is influenced at least to some extent by the structure of the industry including the relative importance of different investment stages and captive versus independent VCists

(Elango, et al., 1995; Wright and Robbie, 1998). It is thus necessary to have some understanding of the different structural composition of individual VC markets.

The empirical results in this paper focus on the stage in the appraisal process after a proposal has passed through initial screens and had reached a stage where detailed valuation and assessment of potential returns takes place. During this stage there is a need for firm-wide policies on due diligence and valuation methods as well as access to detailed accounting and financial information. This section discusses each of these aspects in turn.

Structural Differences in Venture Capital Markets

From major initial developments in the US, there has been a diffusion of VC market growth first to the UK and then throughout Europe and beyond. Tyebjee and Vickery (1988) note the variation in maturity of different VC markets in Europe, while Roure et al. (1990), Ooghe, et al. (1991) and Murray (1995) argue that market development is likely to be associated with greater competition, reduced rates of return and a shift to later stage investments. Roure et al. (1990) also show that greater market maturity is associated with entry by a greater variety of funds' providers, especially by pension funds and insurance companies. Ooghe et al. (1991) support this view and in addition find that public sector funds' providers are more likely to exit. They moreover point out that VC industries in different countries have unique characteristics which are associated with different behaviour between countries.

Table 1 shows some important characteristics of the VC industries in the five countries of our study. In absolute terms, the markets differ quite substantially, with the US market being larger than the other four markets combined, and the UK in turn being larger than the other three continental European markets combined. The markets also vary considerably in relation to countries' GDP in 1995. The annual investments made by US VCists in 1995 was 0.05% of GDP. In Europe, while the UK VC industry amounts to 0.31% of that country's GDP, in France the comparable figure is only 0.07%, in the Netherlands 0.15% and in Belgium 0.06%.

The French, Dutch and Belgian VC industries have a much higher proportion of investors that are dependent on a financial institution or on an industrial parent company than their British and American counterparts. A specific feature of the Belgian VC industry is that the government-backed VCCs play a very important role.

European VCists invest much less in early stage ventures than American ones, while expansion investments are more popular. Management buy-outs represent nearly 65% of the amounts invested in the UK, while expansion capital forms the largest single investment stage in the Netherlands, France and Belgium.

The Valuation Method

The expertise of VC executives may be expected to develop over time. Such expertise means greater skills to evaluate proposals. The US market was the first to emerge, followed in Europe by that in the UK. Venture investment practices spread from there to continental Europe starting with the Netherlands (Manigart, 1994; Wright, et al., 1992). Markets may develop both at different rates and with different emphases, one aspect of which is the role of valuation.

Valuation methods and information usage may moreover be influenced by the dominant corporate culture in a particular country. As capital markets are more dominant in Anglo-American countries, it may be expected that the valuation process is both more developed and more likely to rely on standard corporate finance theory developed in an advanced capital market context. Evidence of differences in appraisal techniques used by investment analysts in the UK and Germany has been attributed to differences in the importance of stock markets between the two countries. German analysts are found to place more emphasis on technical analysis than their UK counterparts who place more emphasis on net assets per share and dividend growth models (Pike, et al., 1993). Efficient and developed capital markets may furthermore provide comparator valuations, either in terms of prices at which companies are traded (takeovers) or sector price/earnings ratios. This information may in practice be weighted more heavily than DCF based methods which are influenced by the choice of discount rate and uncertainty over expected cash flows. In countries where holding and networking structures predominate, such as France, Belgium and the Netherlands (Moerland, 1995), long term relationships are important and the frequent valuation of companies may be less important.

Information for Valuation

VCists place great emphasis on financial information, especially projections, in their assessment of potential investees (Manigart, et al., 1997), but such information may be subject to considerable error and variation. Besides financial information, VCists considering start-ups may place great reliance on evidence concerning an entrepreneur's track record as a means of gauging the likelihood that performance will be delivered (MacMillan, et al., 1987), notwithstanding evidence that previous experience carries liabilities as well as assets (Starr and MacMillan, 1991) and that it is typically difficult to identify an attractive venture second time around (Wright, et al.,1997).

The role of financial information versus information relating to entrepreneurs may vary between countries. Sapienza et al. (1996) have shown that France and Belgium, whose VC markets are relatively young compared to those in the UK and US, are more financially oriented in that the investors often have a financial or banking background and that an important part of the investment companies are subsidiaries of larger financial institutions. This means that investors in these countries provide much less added value to the investee companies. In the same vein, it may be that more financially oriented VCists will rely more on financial and accounting information, while others will emphasise information on the entrepreneur and the management team, or market and product information.

On the other hand, in countries characterised by market-based systems, publicly available financial information is crucial to the functioning of capital markets. However, even in market-based systems, the information relating to early stage ventures is likely to be limited and surrounded by considerable uncertainty. In network-based systems such as France, Belgium and the Netherlands (Moerland, 1995), greater emphasis may be placed on information relating to the individual entrepreneur than in market-based systems such as the US and UK.

Differences between venture capitalists

Differences may arise between VCists in respect of this detailed process of scrutiny. While information on individual entrepreneurs may be important for early stage investments, in buy-outs and buy-ins there are further issues. Where such investment stages involve private/family businesses there will be an independent track record available. Where they involve divested divisions, prior reporting requirements may mean that accurate historical information is difficult to construct ex post (Wright and Coyne, 1985). Further problems occur in that while buy-out managers have been running the enterprise they were not equity owners, and while buy-in entrepreneurs may have a track record this does not relate to the entity which they are acquiring (Robbie and Wright, 1996a).

Depending on the focus of the VC industry in a particular country, executives within it may also have very different skills. The US VC market involves a substantially greater proportion of funds going to early stage ventures than is the case in Europe (Bygrave and Timmons, 1992; 1999), which suggests a greater need to emphasise the skills of the entrepreneur and the market prospect of a new product. Sapienza, et al. (1996) find, for example, that the Continental European VC industry in general is more financially oriented than that in the US. Wright and Robbie (1996b) find that the skills required for the early and buy-out stages of a VC market are markedly different. While the latter requires predominantly financial skills, the former emphasises industry specific knowledge and an ability to assess and work with entrepreneurs. However, growing recognition of the need to achieve returns in MBOs and MBIs from adding value rather than straightforward restructuring also suggests that entrepreneurial and product information and skills are important.

Independent VCists are typically funded through limited-life closed-end funds. Captives are funded primarily by banks and insurance companies. Evidence suggests there may be important differences in investment time horizons for particular investment stages and harvesting methods between VC firms in differing countries (Wright, et al., 1993; and Bleackley, et al., 1996). To the extent that VC investments are funded by independent limited life closed end funds this may also influence the expected investment time horizon, since these funds more than non-independents (captives) are more likely to be committed to generating a return for investors through realising a capital gain within a more clearly specified period of time (Wright, Robbie and Chiplin, 1997). In the UK and the Netherlands, independent VC firms account for a substantially greater share of investments than is the case in the other countries covered by this study (table 1).

DATA AND RESEARCH METHOD

In order to empirically study the differing approaches to valuation and use of accounting and financial information in different countries postal questionnaires have been administered to representative samples of senior venture capital executives in each country. A draft questionnaire was developed in the UK and pre-tested with VCists, advisors and academics (Wright and Robbie, 1996a). The questionnaires were translated into French and Dutch. They were sent to the full members of the British VC Association in early 1994 and to the full members of the 'Association Française des Investisseurs en Capital Risque', the Belgian Venturing Association, the 'Nederlandse Vereniging voor Participatiemaatschappijen', to the French, Dutch and Belgian members of the EVCA in late 1995 - early 1996 and to 299 US VCists in late 1996. Follow-up reminders were sent after two to three months. The questionnaires were sent to senior investment managers. This paper is concerned with the general policies adopted by VCists. An organisation-wide response was sought, with the covering letter to senior investment managers specifically asking respondents to report institutions' perceptions rather than individual approaches; piloting suggested that these policies were generally decided on a firm-wide basis. In framing the initial UK-based questionnaire, discussions with VCists had suggested that during the stages with which this study is concerned, there is close adherence to firm-wide policies.

The response rate was as follows : 66 completed and useable replies out of 114 questionnaires sent in the UK (58% response rate) ; 72 out of 299 in the US (24% response rate) ; 32 out of 133 in France (24% response rate) ; 24 out of 58 in the Netherlands (41% response rate) and 14 out of 28 in Belgium (50% response rate). The venture managers, who filled out the questionnaires, were very senior : the median number of years work in the venture sector of the respondents varies between 9.5 years in Belgium and 14 years in the Netherlands. The US and the Netherlands have the highest proportion of independent companies in the sample (74% and 60% respectively – see table 2), while more French companies are dependent on financial institutions (44%). The VCCs in our sample represent 81% of all new VC investments in the UK, 25% in France, 58% in the Netherlands and 86% in Belgium ; this shows that the sample includes the most important investors, certainly in the European countries.

Country differences with respect to valuation methods and information used will be reported. However, country differences may be due to differences in the venture industry, rather than to between-country differences. If the VC industry in a particular country is dominated by early stage investors, it is likely that information and valuation methods used will be different from the practices in industries, dominated by later stage investors. It is equally likely that managers from independent VC firms may behave differently from those from VC firms, dependent on a parent company or on government. Therefore, we tested for the interactive effects of country, investment stage preferences and type of VCC. [1] In the remainder, we will only comment upon significant ($p<0.1$; 2-sided tests) interaction effects between country and investment stage preferences, or between country and type of VCC (dependent versus independent).

Table 2 gives the number of VCCs, split up according to their investment preference and their governance mechanism (independent or not). It is clear that the US VCCs are more keen to invest in early stage deals than the European ones. More US VCCs are independent, while European VCCs are more likely to be dependent on a parent company or on government.

EMPIRICAL RESULTS

Valuation Method

Table 3 reports the country averages, standard deviations and within-country ranks of the use of valuation techniques, with 1=never used and 5=always used ; the valuation techniques are ordered in the table from most used (highest average over the five countries) to least used. There is a wide variation between the countries in the use of valuation methods. The most popular valuation techniques are prospective or historic price/earning multiples in the UK, EBIT multiples and recent transaction prices in the sector in the US, discounted cash flow (DCF) techniques in Belgium and the Netherlands and responses to solicit bids for the potential investee or recent transaction prices in France. It is hard to explain the differences in approach between the countries with arguments like the maturity or structural differences of the VC industry or the dominant corporate governance system. For example, the American and French valuation approaches are more similar to each other, while these countries differ widely in terms of industry maturity or governance system.

Textbook valuation techniques, such as DCF, dividend yield and payback, are in general less important than price/earning or EBIT multiples, although DCF is the most popular method in Belgium and the Netherlands. It is, however, not as frequently used in France as in the other countries. The dividend yield method is least popular in the US and the UK, but also infrequently used in the other countries of the study. Considering the nature of VC investments, where dividends are the exception rather than the norm, this comes as no surprise.

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1 Due to space constraints, we do not report the full results of the ANOVA tests. These may be obtained from the authors upon request.

Relationship-based valuation techniques, e.g. responses to solicit bids for the potential investee or industry's rule of thumb ratios, are most popular in France, the most network-oriented country in our sample. They are, however, less popular in Belgium and in the Netherlands than in the US and the UK.

Finally, accounting-based measures, such as book value or liquidation value, are least popular everywhere, but they nevertheless show significant differences between the countries. French later stage, independent investors, prefer historic cost book value or third party bids, while independent generalist investors use more frequently liquidation value of assets, and especially so in the US.

The subjectivity of valuations is an international phenomenon, with all countries scoring highest the placing of the greatest weight on one particular valuation method and using the others as a check (table 4). The weighted average method was significantly more important in Belgium and the Netherlands. Using one value, either the median, the lowest or the highest, is almost never done in any of the countries.

Information for Valuation

The respondents were asked to rate 22 possible sources of information for valuation purposes, with 1=never used and 5=always used ; the information sources are ordered in table 5 from most used (highest average over the five countries) to least used. The means, standard deviations, within-country ranks and significant differences between the countries are reported in table 5.

The most important source of information in each country is the own due diligence report, except in France, where this item is rated second. The overall coherence of the business plan is the first (France), second (US) or third (UK, Belgium and the Netherlands) most important information element : telling a good story is important everywhere when trying to raise capital. The different parts of a business plan, such as P&L account, balance sheet and unaudited management projection, are very important in the European countries, receiving an average score of 4 ('very important') or higher ; these information sources are significantly less important in the US. Further accounting information, such as a qualified audit report or long term management projections, together with due diligence by outside experts such as consultants or accounting firms, are significantly more used in Continental Europe than in the US and UK. This finding is consistent with Sapienza, et al. (1996), who found that Continental European VC funds and managers are more financially oriented, while Anglo-Saxon VC managers are more business oriented. Accounting information is therefore more valuable as a source of information in the former countries than in the latter.

Apart from the numbers, who you are is important : curriculum vitae of the management team and interviews with the entrepreneur(s) are just slightly less important than the business plan. There are, however, significant differences between countries in respect of the importance of the four information items relating to individuals. American VC managers consider the curriculum vitae and interviews with entrepreneurs as second (ex-aequo with the overall coherence of the business plan) and fourth most important item in the valuation process, well ahead of the accounting elements in the business plan (P&L, balance sheet, projections). Compared to their colleagues, British VCists place the least importance upon interviews with the entrepreneurs and other personnel, and upon the curriculum vitae of the management team. French, Dutch and Belgian VCs place relatively higher emphasis on these information sources, implying that even for these more financially-oriented VC managers the entrepreneur and his/her team are important in making a venture interesting.

Information on sales and marketing, product information and production or technical information are, generally speaking, less important, except in France. Surprising is the low score for other venture capitalists as source of information, as “sharing information” is often cited as one of the most important reasons for syndicating VC deals (Bygrave, 1988). Publicly available information, such as financial press, trade journals or government statistics, are unimportant.

Differences Between Venture Capital Firms

In this section we summarize the major findings of the survey relating to differences between types of venture capital firms. When taking investment preferences and type of VCC ownership into account, UK later stage investors place much more emphasis on P/E multiples based on historic figures, while French later stage, independent and captive investors prefer historic cost book value or third party bids. It is furthermore striking that captive US investors use the dividend yield basis more frequently than captive European investors, while the reverse is true for the independent investors. Finally, independent all stage investors use more frequently liquidation value of assets, and especially so in the US.

The overall coherence of the business plan, which is the most important information source in France, is even more important for captive than for independent venture capital managers in that country. Later stage investors place a higher emphasis on a qualified audit report, especially in France, and on unaudited financial statements or unqualified audit reports, especially in the US and in the UK. This makes sense, given that accounting figures are often less informative for startup companies than for later stage companies.

DISCUSSION AND CONCLUSIONS

Previous evidence has focused on the information and valuation issues which concern VCists in the UK (Wright and Robbie, 1996a). Our results have shown that it is not possible to generalise from UK evidence to other countries. There are important between-country differences with respect to the due diligence and valuation stages of VC investment and the relative importance of accounting and financial information in this process.

The valuation methods used to combine the information on risk and required return differ widely across the countries. Although it might be argued that countries with less developed capital markets are less likely to utilise valuation techniques consistent with standard corporate finance theory (e.g. DCF, dividend yield, ...), this was not consistently the case. There were indications that apparently similar systems and markets are in fact heterogeneous. For example, PE ratios, which might be expected to be widely used in more developed capital markets where it is possible to make comparisons with other companies for which information is publicly available, were most important in the UK but not in the US. More research is needed on this subject.

We empirically showed that who you are and who you know is more important in network-based economies (France, Belgium) than in market-based economies (US and UK). When gathering information for the valuation process, personalities of the entrepreneurs, information provided by the management team and personal references are more important in network-oriented countries, such as France, than in market-oriented countries, such as the UK or the US, irrespective of the investment stage.

Investors in older VC markets, such as the US and the UK, rely more heavily upon their own due diligence and market reports. This finding may also be caused by the more financial orientation of VC investors in the younger VC markets in our study, namely France and Belgium.

Our research shows that the behaviour of VC investors varies widely. Some of the differences can be attributed to the dominant corporate governance mechanisms used in the countries, some to the stage of development of the venture industry. VC investors may gain from the sharing of their experiences and practices with investors from other countries. It is possible that the internationalisation of the VC industry will induce more common practices over time, but until then, this study provided further evidence of the fragmented nature of this industry. This emphasises the need for venture capital firms entering non-domestic markets to invest considerable effort in understanding the operation of these markets if they are to exploit fully their perceived competitive advantages and avoid the problems experienced by some previous foreign entrants in the late 1980s.

In moving into non-domestic markets, VCCs are likely to select between a number of potential investee countries rather than focusing straight away on one country. This paper has attempted to contribute to this decision-making process by focusing on providing evidence relating to the general policies adopted by VCs in each country in terms of approaches to due diligence, valuation and use of accounting and non-accounting information. It is recognised that this is only a subset of the whole operation of a venture capital market, but analysis of all aspects would be beyond the scope of a single paper. Further research might usefully address other aspects of the operation of venture capital markets such as deal generation and deal monitoring as well as routes for realizing investments.

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