Does Venture Capital affect capital structure rebalancing? The case of small knowledge-intensive service firms

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Abstract

This study analyses small knowledge-intensive service (SKIS) firms’ capital structure rebalancing, before and after Venture Capital (VC) entry. We use data for a sample of 1,161 Western European SKIS firms, for the period 2006-2015. Two sub-samples were created: one composed of firms before VC entry; the other composed of SKIS firms after VC treatment. We use panel data models and the system GMM (1998) dynamic estimator. The results obtained suggest that after VC entry, SKIS firms are close to the predictions of the pecking order theory. Therefore, SKIS firms after VC participation on firm equity, probably become less dependent on debt, choosing internal finance to fund assets that are firm-specific or have an intangible nature, and, hence cannot be pledged as collaterals.

1. Introduction

Venture capital investors (VCs) have an important role in the business sector, particularly in firms’ revitalization, contributing to wealth creation in various countries’ economies. According to the Invest Europe report (2017), since 2007 European VCs have backed more than 21,000 firms,1 including innovative start-ups in growth, medium-sized firms seeking to develop, and firms with revitalization needs.

VCs are financial intermediaries with distinct characteristics from the traditional finance sources (e.g., banks) which are interested in innovative business ideas, with high potential growth and risk. The impact of the 2008 financial crisis, on reducing the funding by the European banking sector brought an increase of VC investment in Europe. According to the Invest Europe report (2017), venture capital (VC) investment in Central and Eastern Europe, in the year 2015, reached the maximum value since 2009. The total amount of this investment increased by 25% per year to around €16 billion, involving a record number of investee firms in 2015. VCs are investors that not only contribute to financial resources but also assist in investee firms’ planning, management, and strategic decision-making processes, thus being active investors and adding value. Various authors (Bergmann and Hege, 1998; Casamatta and Haritouch, 2004; Félix et al., 2009; Compera, 1995; Lerner, 1994; Nahata, 2006; Sahlman, 1991; Wang and Zhou, 2004) pointed out that VCs certify the quality of the investee firms for the market, which may reduce the problems of information asymmetry and agency. After VC entry, investee firms acquire greater reputation that allows them to obtain credit on more favorable terms (Capizzi et al., 2011).

Schirck et al. (2012) and Strambach (2001) argued that small and medium-sized knowledge-intensive services (SKIS) firms have specificities, which are intrinsically related to the informational...