6 Synthesis

This chapter presents a synthesis of the above theoretical and empirical analyses on cash flow allocations in German augmented venture capital contracts in Chapters 4 and 5. It compares real-world practices with incentive considerations and derives implications for an improved venture capital contract design in the German market.

The comparison of findings is subject to the following limitations. The theoretical analysis is restricted to four out of six cash flow-related covenants, excluding co-sale agreements and staged financing. However, empirical evidence shows that German venture capital contracts always include co-sale agreements, and that German convertible securities contracts and straight equity contracts do not contain staged financing agreements. This implies that the findings on convertible securities and straight equity contracts are not distorted. In addition, the theoretical analysis includes neither contracting time and costs nor possible rejections of complex or unknown financial instruments by portfolio companies. Yet these might differ between the empirically identified contracting patterns and thus define entry barriers to complex contracting.

The first comparison relates to the *optimal equity stake* allocated to the venture capital investor under straight equity financing, that is, also after conversion option exercise.

- The theoretical analysis derives that the optimal contract allocates a *minority share* in the project's return to the venture capitalist and a majority share to the entrepreneur.
- The empirical analysis finds that approximately one third of German venture capital companies report their maximum equity share across their contracts to be a *majority share*.

As a result, the maximum equity share allocated to the venture capital investor should be reduced to below 50% under straight equity financing as well as after conversion option exercise in order to provide optimal incentives to the portfolio company. From this results Implication 1.

Implication 1: *(Optimal Equity Share).* Under straight equity financing, the venture capital company should optimally be allocated a minority share in the portfolio company.

The second comparison refers to the *optimality of augmented contracts.* It contrasts the new pecking order of venture capital contracting with the four main contractual patterns identified in the German market.[355]

First, the pecking order recommends the use of *convertible securities* contracts.

- The theoretical analysis confirms findings in the existing literature on the optimality of convertible securities and extends this proposition by the finding that *convertible securities* with *redemption option* outperform all possible combinations of financial instruments and cash flow-related covenants in terms of their cash flow incentive-compatibility.
- The empirical analysis is an indication that German venture capital companies use *convertible securities* and combine them with *redemption options.*

These findings concur in contracting with convertible securities. They approve that the most sophisticated German venture capital investors choose the most incentive-compatible cash flow allocations. This is summarized in Implication 2.

[355] For a juxtaposition of the pecking order of venture capital contracting and the contracting ladder of venture capital investor sophistication, see Figure 5-7.