



Samuel Neaman Institute

FOR ADVANCED STUDIES IN SCIENCE AND TECHNOLOGY

CAN VENTURE CAPITAL FUNDS PICK WINNERS? EVIDENCE FROM PRE-IPO SURVIVAL RATES AND POST-IPO PERFORMANCE

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SCIENCE, TECHNOLOGY AND THE ECONOMY PROGRAM (STE)
WORKING PAPERS SERIES STE-WP-23-2004



Technion - Israel Institute of Technology

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STE-WP 23

October 2004

An earlier version of this paper appeared under the title “Venture Capital Funds and Post-IPO Performance in Booms and Busts: Evidence from Israeli IPO’s in the US in the 1990’s,” Bank of Israeli Discussion Paper No. 2003-12. We are extremely grateful to Vladimir Lifschitz for his extraordinary contribution to the construction of the database, and to Aryeh Bassov and Konstantin Kosenko for excellent research assistance. We also thank Gil Avnimelech, Marco Da Rin, Saul Lach, Sigal Ribon, Yona Rubinstein, Efrat Tolkowsky, Manuel Trajtenberg, Oved Yosha, Haim Zazak and seminar participants at the Bank of Israel and Tel Aviv University for very helpful comments. This paper presents the authors’ own views and not that of the Samuel Neaman Institute for Advanced Studies in Science and Technology or any members of its staff.

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Abstract

This paper evaluates the ability of venture capital funds to identify and bring to market successful high-tech Israeli companies during the period 1991 to 2000. Using a newly constructed and highly detailed database we find that: (1) The probability of survival until the IPO stage is higher for venture-backed companies. (2) According to several different measures, conditional on making an IPO, the post-listing performance of venture-backed companies is not statistically different from that of non-venture companies throughout the 1990s. We interpret this as evidence that an important contribution of the venture capital industry may be in increasing the survival rates of young technology-intensive firms, rather than in identifying high performers.

Keywords: Venture capital, IPO, survival rate, long-run performance.

JEL Classification: G20, G30.

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I. Introduction

The role of venture capital (VC) funds in financing innovative activities is well documented in the literature (e.g., Gompers and Lerner, 1999). In the presence of severe informational problems regarding the quality of innovative young firms, VC funds are often described as a mechanism to identify promising startups, monitor their progress and advise their management until they reach maturity. By contrast, banks may be reluctant to finance risky early stage activities, and stock markets are typically unable to provide funding to very young companies. VC activity is therefore of particular importance in this respect.

During the last decade, Israel has become a success story of high technology startups and venture capital activity. The venture capital industry in Israel has undergone dramatic changes, evolving from a small, government-sponsored sector in the early 1990s, into a booming private industry with over 100 active funds, investing billions of dollars per annum in the late 1990s. According to some accounts, VC activity in Israel in the 1990s was one of the most intensive in world, exceeded only by California and Massachusetts (Mayer, Schoors, and Yafeh, 2004). Government policy in support of the infant VC industry in Israel has often been described as extremely successful (e.g. Avnimelech and Teubal, 2004a), and technology startups, an important source of growth in the 1990s, have transformed the economic landscape of Israel (Bank of Israel Annual Reports, various years).

The present study attempts to contribute to the VC literature by examining two main hypotheses: (1) Is it the case that VC funds, through monitoring and

assistance, raise the probability of survival of young innovative firms prior to their “exit”? And (2) Conditional on survival until the exit stage, do VC-backed companies outperform their peers (according to several different criteria) after the IPO?

In order to examine these two hypotheses, we use a newly constructed database containing detailed information on *all* Israeli VC funds and on their *entire* portfolios of client companies, providing a unique opportunity to observe both pre-IPO survival rates and post-IPO performance. To the best of our knowledge, the combination of pre-exit and post-exit measures of performance is novel in the VC literature.

The paper presents two main sets of results, corresponding to the two hypotheses. First, we provide evidence in support of the first conjecture: in comparison with other high-tech firms, the probability of survival until the exit stage is significantly higher among VC-backed companies, even though their observable characteristics appear to be not very different from those of non-VC backed companies. With the exception of Manigart (2003), we are not aware of such an analysis of pre-IPO survival rates.¹

Second, in contrast with the conjecture that VC funds are capable of “cherry picking,” we find no evidence of superior post-IPO performance of VC-backed companies in comparison with their non-VC-backed peers. These conclusion holds when examining initial valuation (at the time of the IPO), 36-month stock performance, accounting profitability and asset growth rates in the three years

¹ Jain and Kini (1999 and 2000) address issues related to post-IPO survival.

following the IPO; VC finance is not associated with superior post-issue performance according to any of these measures.

Taken together, the high survival rate of VC-backed companies prior to the IPO and the absence of a difference in their post-IPO performance relative to their peers can be interpreted as follows. A plausible contribution of the VC industry to economic growth is in the reduction of mortality rates among high-tech firms (perhaps through monitoring and guidance); by contrast, there is not much evidence in support for the conjecture that VC funds identify star performers. This conclusion holds even when we control econometrically for the possibility that VC's select "strong survivors." Our findings can therefore be summarized by the following analogy: it is not true that "students" of the VC "school" achieve the highest exam scores (post-IPO performance); their "grades" appear to be similar to those of other "students" (firms). However, the probability of reaching the "high school graduation stage" (IPO) is much higher for VC clients, and this may be their main contribution to social welfare.

The present study is related to the large literature on the economic roles of the VC industry (e.g. Gompers and Lerner, 1999 and 2001; Hellman, 1998 and Hellman and Puri, 2000; Lerner and Kortum, 2000). It is also related to studies of post-IPO stock performance of high-technology companies such as Brav and Gompers (1997) and Blass and Yafeh (2001), and to studies comparing the long-run performance of IPO firms more generally (most notably, Ritter, 1991). Also related is the study of Jain and Kini (1995), who, in contrast with our results, find superior post-IPO accounting performance of VC-backed firms in the US, as well as higher initial valuations. Manigart (2003) examines the survival rate and some operating measures

of performance for VC-backed and other (unlisted) Belgian firms. Her results also differ from ours: VC-backed Belgian start-ups do not have higher survival rates, but at least some of them do grow faster (prior to the exit stage), albeit with higher volatility. Engel and Keilbach (2002) find faster growth for German-backed VC companies (also prior to the exit stage), but not higher patenting rates. Examining companies listed on Europe's "new markets," Botazzi and Da Rin (2002) do not find any evidence to suggest that VC-backed companies fare better than other high-tech companies in terms of growth rates or stock prices. Our study fits into the existing literature, which has not been able to show unambiguously that VC-backed firms fare "better" than their peers do after exiting. However, the combination of pre-IPO and post-IPO information on the performance of VC clients suggests that the contribution of VC funds is more in evidence in early, pre-exit stages, than it is in later, post-exit performance.

The rest of the paper is organized as follows. The next section describes the database used for this study, and provides some background information on VC activity in Israel since the early 1990s. In Section III we compare the pre-IPO attributes of VC client firms with those of other high-technology companies, and discuss their survival rates. Section IV contains the empirical analysis of post-IPO performance. Further discussion of the results and some conclusions are offered in Section V.

II. The Data

The data set used in this study is constructed by combining and updating two data sets. The first is the data set used in Ber (2003), extended and updated through

2002, containing information on all the start-ups that were included in the portfolios of all Israeli VC funds at any point between 1997–2002 (661 companies; similar data for earlier years are unavailable).² The database provides detailed information on each company supported by a VC during the period, including its line of business, firm characteristics, and status (on-going with VC support, closed/deleted from the VC’s portfolio, or performed an “exit:” IPO, private sale, or merger). Because most of those companies are private, this information is not available to the general public, and was gathered primarily from reports of the Israel Venture Capital Association (IVA), to which all Israeli VC funds report. Alongside these data, information was collected for a control group of high-tech companies that were not supported by an Israeli VC fund and raised capital from non-VC sources, primarily from investment companies that focused on financing high technology, but were not organized as VC funds. (Data are also from the Israel Venture Capital Association). Many studies have argued that the organization of VC funds (for example, as limited partnerships) and the contracts they use are particularly suitable for investment in high technology (Kaplan and Stromberg, 2003, for example). If the organizational form of VC funds is indeed crucial for VC’s to be able to successfully select and advise client firms, then high tech firms financed by investment companies not organized as VC funds constitute a particularly suitable control sample. We therefore use these data to examine the relative survival rate of VC-backed companies.

The second database we use, constructed by the Bank of Israel, contains information on the accounting and stock-based performance measures for all Israeli

² Israeli VC funds are those listed in the Israeli Association of Venture Capitalists, regardless of their sources of funds or ownership. The data set does not include information about foreign VC funds operating in Israel.

high-tech companies listed on NASDAQ. This information is used to compare the post-IPO performance of 51 VC-backed IPO's in comparison with 38 other high tech firms that went public between 1991 and 2000.³

In the analysis that follows, we draw conclusions on the pre-IPO survival rates and post-IPO performance of VC-backed firms as if the two data sets contained information on the same firms in different stages of their life, before and after the IPO. In practice, however, the pre-IPO characteristics and survival rates of VC-backed and other companies refer to the period 1997-2002, whereas the comparisons of post-IPO performance are based on information on companies that went public between 1991 and 2000. The discussion and conclusions that we draw are therefore based on the plausible assumption that both the pre- and post-IPO differences between VC-backed and other high-tech companies are a general phenomenon, which applies to periods beyond the sample years.⁴

The VC Industry in Israel

We briefly review the evolution of the VC industry in Israel; for further details, see Avnimelech and Teubal (2004b) and Ber (2003). Prior to the 1990s there existed no VC industry in Israel. The industry was created as a result of the initiative

³ The overwhelming majority of IPO's by Israeli hi-tech companies takes place on NASDAQ, not on the Tel Aviv Stock Exchange (there have only been three cases of a VC-backed IPO on the Tel Aviv Stock Exchange), and by the late 1990s, the number of Israeli companies listed on NASDAQ exceeded the number of all other foreign firms combined (excluding Canadian companies). With very few exceptions, these companies belong to high-tech industries; see Blass and Yafeh, 2001, for a detailed discussion of this unusual phenomenon. Because NASDAQ high-tech IPO's tend to perform better than the IPO's on the domestic market (Blass and Yafeh, 2001), our data constitute a comparison of VC-backed issues with the best non-venture-backed technology IPO's.

⁴ During the overlapping period of 1997-2000, the database we use for the analysis of the pre-IPO survival rate covers 26 of the 38 firms that went public during these four years. The remaining 12 companies must have been financed through non-VC entities which are not included in our control sample.

and direct involvement of the government in 1991. In that year it was decided to support the establishment of VC funds in Israel by providing government guarantees for the purchase of shares in funds via the “Inbal” government insurance company. In this framework, three VC funds were founded in 1991–93 and their investments were guaranteed by the state. In 1992, the “Yozma” government VC fund was set up in order to establish VC funds in cooperation with private foreign investors, and was allocated equity of \$ 100 million. Until its dissolution, the fund, which was set up for a limited period of seven years, supported the establishment of ten private VC funds, which together raised a total of \$ 2.7 billion by 2000. At present, the government is no longer involved in the VC industry in any way, and the sector is comprised entirely of private entities. By mid-2000 Israel’s VC funds—which are registered with the Registrar of Companies—managed \$5 billion of capital via 62 management companies, controlling 97 funds. Finance raised by the funds in 2000 amounted to 2.7 percent of GDP—a particularly high rate compared to other countries (in the US, for example, it was 0.7 percent of GDP at that time). This ratio declined in 2001 and 2002 due to the sharp fall in financial markets, but remained relatively high even during these years: 1.8 and 1 percent, respectively. For further information on the sectors and stages of companies receiving VC finance in Israel, and on the organization of VC activity (sources of finance, fund type, contracts between VC funds and recipient companies, etc.), see Ber (2003) and Mayer, Schoors, and Yafeh (2004).

Despite the large number of VC funds operating in Israel, for most of the 1990s, the market was characterized by a relatively high level of concentration, with the five largest funds managing about 25 percent of the industry’s capital. However, Table 1 suggests that the booming years of the late 1990s led to significant entry and

de-concentration of the VC industry. The sharp fall in financial markets since 2000 increased the incentive of funds to merge and consolidate their activities; although it seems that changes in this direction have so far not been very large, the preceding trend of de-concentration and entry seems to have been reversed.

III. Recipients of VC Finance and their Pre-IPO Survival Rates

Panel A of Table 2 presents some descriptive statistics on high-tech companies in the portfolios of VC funds and non-VC investment companies between 1997 and 2000. The two samples appear to be quite similar in terms of age, median (though not mean) size, and, with some exceptions, type of activity. Panel B presents probit regressions attempting to characterize the recipients of VC finance. The predictive power of these regressions is poor, and the number of correct predictions is very close to the number that could be predicted by simply using the proportion of VC-backed firms in the sample. We conclude that it is hard to predict who will receive VC finance based on observable firm characteristics.

Table 3 describes changes in the portfolios of VC funds and other investment companies. A striking feature of Panel A is that the fraction of companies deleted from the portfolio of VC funds between 1997 and 2002 (due to business failure or bankruptcy) - about a quarter - is less than half the corresponding figure for non-VC investment companies. Over half of the portfolio of the non-VC investment companies failed, mostly between the years 2000 and 2002. Panel B shows several (simple and ordered) probit specifications indicating that, controlling for firm characteristics, the probability of being deleted from the portfolio of a non-VC investment company during the period 1997-2002 was significantly higher than the

probability of being deleted from the portfolio of a VC fund. In addition, the regressions show that the probability of reaching the exit stage was also higher for VC-backed firms (during the 1997-2002 period about 28 percent of the firms in the portfolio of VC funds “exited,” versus slightly more than 10 percent of the non-VC backed companies in the sample).⁵ The main conclusion from Table 3 is therefore that there is substantial evidence of higher survival rates among VC-backed firms.

For completeness’ sake, we also document new companies added to the portfolios of VC and other non-VC investment companies between 2000 and 2002. We find that a large number of new start-up companies that received funding. During the difficult years of 2001 and 2002 VC funds provided finance to nearly 330 firms! We interpret this as evidence that the VC industry is very much alive despite the recession in Israel and the falling technology stock prices in the US.

IV. The Post-IPO Performance of VC-backed and Other IPO’s

In this section we examine the hypothesis that the ability of VC funds to identify “cherries” is reflected in at least some measures of post-IPO performance of VC-backed firms.

Comparison of Valuation at the Time of the IPO

⁵ In one probit specification we also control for the “average reputation” of VC funds that finance each company. Reputation is measured as the percent of firms in the VC’s portfolio that exited during the fund’s life (the mean value of this variable is about 13 percent). This statistic is averaged across all funds that finance each company because the individual contributions of each fund are unknown. We find no evidence that VC fund reputation is associated with higher survival or exit rates. The results are similar (i.e. fund reputation has no effect) if reputation is measured by the size of the fund’s portfolio or by its age, in both ordinary probit and ordered probit specifications. Similarly, when we introduce variables measuring the reputation of non-VC investment companies, we do not find any significant effect (not shown).

We begin by investigating whether differences in quality between VC-backed and other IPO's are reflected in the valuation of companies when their shares are offered to the public. On average, VC-backed IPO's are somewhat higher valued (both in absolute terms – \$58m vs. \$43m - and in terms of market to book ratios), but these differences are far from being statistically significant. Next, we run multivariate regressions where the dependent variable is initial valuation and the right-hand-variables are IPO cohort (1996-2000 boom years vs. the early years), total pre-IPO assets, and a VC-backed company dummy. The coefficient on the VC dummy is essentially zero, so that there is absolutely no evidence that VC-backed IPO's are priced differently than other issues (Table 4). The results are similar when market to book ratios are used instead of valuation.

Comparisons of Stock Returns for VC-backed and other IPO's

Next, we turn to a decade-long comparison of stock returns for the first three years following the NASDAQ IPO of VC-backed and other Israeli high-tech companies. Is it the case that initial valuations did not fully anticipate the subsequent performance and VC-backed companies “surprised” investors?

To address this issue, we calculate post-IPO stock returns using two different methods described in Ritter (1991). In both methods, the excess (or abnormal) return for firm i in month t after the IPO is defined as the difference between the return on the firm's equity and the market (NASDAQ) return. More sophisticated excess return calculations relative to a (matched) “reference portfolio” (e.g. Brav and Gompers, 1997) are not feasible in our case because of the sample size and because of the absence of comparable (Israeli) firms to which Israeli IPO's in the US should be

compared. This is not a severe handicap, however, given that our objective is not to measure long-run excess returns in the most precise possible manner, but rather to compare the returns of venture-backed IPO's relative to non-venture backed issues. The calculations that follow ignore the return on the first day of trading, which are typically highly positive due to the well-documented phenomenon of "underpricing."

In the first approach, we calculate "buy and hold" cumulative abnormal returns for 36 months following the IPO under the assumption that the shares bought at the IPO are held for the entire period. For each company we calculate cumulative returns in excess of the NASDAQ index for a three-year period, and then calculate the (simple) mean and median returns for the sub-samples of VC and non-VC-backed IPO's.

The second calculation method proceeds as follows. Again, we begin by calculating the abnormal return for each company in every month t , where t equals 1 to 36: $ar_{it} = r_{it} - r_{mt}$, where r_{it} is the return on company i 's stock in month t and r_{mt} is the NASDAQ index return in the same month. We then calculate the (simple) mean (or median) abnormal return for every month t , AR_t , for the sub-sample of VC-backed companies and for the sub-sample of non-VC-backed companies separately. For each of the two sub-samples we define the cumulative abnormal return, CAR_t as the sum of the mean abnormal returns, AR_t from month 1 to month t . This calculation method assumes "re-balancing" of the portfolio every month, so that gains or losses in

previous months are ignored and each month begins with an equal investment in all IPO cohorts.⁶

In order to test hypotheses about the CAR of VC-backed IPO's in comparison with other firms one needs to derive standard errors for the mean or median sample CAR. Although Ritter (1991) offers a method to derive the standard errors for his proposed CAR statistics, recent studies often use statistics derived through bootstrapping techniques (e.g. Hertz et al., 2002). The use of standard errors based on bootstrapping is a way to get around the fact that the distribution of excess returns is rarely normal and typically unknown.

Table 5 and Figure 1 present the estimated cumulative excess returns (CAR) for VC-backed and other companies for 36 months according to the "buy and hold" method; the results for the second calculation method are qualitatively similar and appear in the Appendix. In line with the well-documented phenomenon of long-run under-performance of IPO shares (Ritter, 1991) the returns on both groups of issues fell far below the NASDAQ index.⁷ More interestingly, there is little to suggest that VC-backed IPO's exhibit higher returns than other issues. According to the calculation presented in Table 5, VC-backed IPO's fared better than their non-VC-backed peers, but the variance within each sample is so high that, using Ritter's (1991) standard errors, it is impossible to reject the null hypothesis that the mean and median CAR are in fact equal. The absence of significant differences in post-IPO

⁶ Our calculations are based on simple means rather than on size-weighted averages. This is because of the sample size and because of the difficulty in assigning size-based weights to IPO's in different time periods.

⁷ Ritter (1991) documents lower negative abnormal returns of about -30 percent over a three-year period for his sample of American IPO's. His interpretation of this phenomenon is of a "hot market" effect, whereby firms schedule their IPO's in a period when demand is particularly high, and investors are perhaps "over-optimistic."

stock returns between VC-backed and other IPO's is corroborated also by the second CAR calculation (see Appendix).

To verify the robustness of this finding we repeat the analysis using bootstrapped standard errors to gauge the significance of the difference in mean stock returns between VC-backed and non-VC-backed issues. The calculation of standard errors using bootstrapping is based on drawing 1000 samples of VC-backed and non-VC-backed IPO's (with replacement) and calculating the likelihood that the observed difference in the mean 36-month CAR between the two sub-samples is "unusually high" (see Efron and Tibshirani, 1993, for technical details). The results are displayed graphically in Figure 2. It is impossible to reject the hypothesis that the mean CAR is in fact equal for VC-backed and other IPO's (the p -value is 0.15); The actual difference in mean CAR between the two samples is close to the center of the distribution of the differences in the 1000 draws.⁸

We now turn to the issue of clustering of IPO's in certain time periods. First, we divide our IPO sample into two cohorts, the first half of the 1990s and the "boom years" (1996-2000). This is because the incentives and ability of VC funds to pick successful companies may have been different in the early 1990's and in the hot market of the second half of the decade. Although Israeli IPO's on NASDAQ fared worse relative to the index in the boom years, we find that the performance of VC-backed IPO's during both periods was very similar to that of non-VC-backed IPO's (Figure 3). The differences are not statistically significant at conventional levels and

⁸ Mitchell and Stafford (2000) argue that conventional measures of statistical significance are often overstated because of "clustering" - the fact that observations which belong to the same cohort or industry share some common features and are therefore not truly independent. They propose a solution - comparisons of calendar-time portfolios of firms - that is not feasible for our small sample. However, if, as they argue, the bootstrapped standard errors we calculate may be too small, the correct p -value for the difference between VC-backed and other IPO's is even smaller than the figure reported above.

neither are the differences in medians.

Next, Table 6 presents regression results where the dependent variable is each firm's cumulative abnormal return during the 36-month period following its IPO. Right-hand-side variables include controls for industry, cohort and, in some specifications, age and firm size (assets) at the time of the IPO.⁹ Even after controlling for these observable characteristics, there is still no difference between the returns of VC-backed and other IPO's.

Finally, the last column of Table 6 displays a regression specification that takes into account the fact that Tables 5 and 6 are based on "survivors" only, i.e. on firms that "made it" to the IPO stage. This specification is designed to address the possibility that reconstructing the original distributions of VC-backed and other companies might change our impressions on the relative performance of the two types of firms and on the impact of VC's on post-issue performance. Using the (simple) probit regression in Table 3B, which explains the likelihood of survival until the exit stage, we generate for each firm a propensity score (ranging between zero and one) and an inverse Mills ratio. These should be treated with caution; only 26 of the 89 IPO's in our sample (with IPO dates are between 1997 and 2000) are included in the probit regression (see footnote 4). For the other firms, propensity scores and Mills ratios are "fitted values" derived from the coefficients in Table 3B. The regression results with the propensity score (shown) and the inverse Mills ratio (not shown) corrections for sample selection remain unchanged. We conclude that, even after correcting for the possibility that the sample of firms that reached the IPO stage is

⁹ We control for age because VC-backed IPO's tend to be relatively young when they go public (with a mean age of about 8 years) in comparison with non-VC backed companies (where the average age at the time of listing is 11.6 years) – a statistically significant difference.

non-random, there is still no evidence that VC finance is associated with superior stock returns.¹⁰

Comparisons of Risk and Return Distributions

Our estimates so far have detected no systematic differences in long-run mean and median stock returns between VC-backed and other IPO's. We now examine whether the entire distribution of post-IPO stock returns is different for the two sub-samples. Figure 4, which portrays the distribution of returns for the two sub-samples, suggests that the distributions are very similar. More formally, we conduct a test for the equality of the variances of the two sub-samples and cannot reject the hypothesis that the two are equal. Furthermore, stochastic dominance tests (Kolmogorov-Smirnov test of equality of distributions, and Wilcoxon (sum-of-ranks) test) strongly suggest equality of the two distributions: the p -values associated with the tests are 0.44 and 0.26, respectively. Finally, we also use bootstrapped standard errors to compare the two distributions, and again, find no statistically significant difference between them – the p -value associated with this test is about 0.5 (see Efron and Tibshirani, 1993, Chapter 16). We conclude that stock returns on VC-backed IPO's and other high-technology issues are drawn from a similar distribution. This is despite the finding that the rate of survival (the probability of reaching the IPO stage) is higher among VC-backed firms, an issue to which we will return below.

¹⁰ Another regression specification that we examine includes interaction terms between the IPO cohort and all the explanatory variables. The results (not shown) do not suggest any significant changes between the early 1990s and the later years (the only exception is the coefficient on the health and life science industry that becomes negative in the later years).

It is impossible to assess the relative return on VC-backed IPO's without investigating risk as well. First, we examine the standard deviation of the monthly abnormal returns for each firm, and find no difference in this measure of volatility between VC-backed and other IPO's. *Betas* for VC-backed companies are slightly higher than for other IPO's (about 1.1 relative to 0.9, and this difference is statistically significant), so that there is no reason to suspect that VC-backed issues are superior in that they offer lower risk than other technology IPO's.

Accounting Measures of Post-issue Performance Sample Selection Issues

Turning to accounting measures of post-issue performance, Table 7 suggests that there are virtually no statistically significant differences between VC-backed IPO's and other firms in commonly used measures of profitability (ROA, net profits to assets, and pre-tax profits to assets). Mean asset growth rates are much higher on average for VC-backed IPO's, but as in the case of initial valuations, the variance within each sub-sample is high. (The difference in growth rate is significant only at the 10.5 percent level).¹¹

V. Discussion and Concluding Remarks

The contribution of VC finance to the development of high-tech industries has been the subject of a large and growing literature. The present study argues that much of the contribution of venture capitalists is in evidence in pre-IPO survival rates, not

¹¹ (a) Data limitations reduce the sample size in some of the rows of Table 7. The results on post-IPO stock returns (the absence of a significant difference between VC-backed and other issues) hold for each of the sub-samples used in this table. (b) Table 7 displays means; the absence of significant differences remains unchanged when medians are used instead. (c) One measure of post-IPO performance that we do not address here is the failure or bankruptcy rate. This is simply because none of the companies within our sample went bankrupt during the three years following its IPO.

in post-IPO performance. One way to interpret this result is by imagining a “childhood disease” with a mortality rate that affects young high-tech firms of *all* types between their inception and the time of their IPO. Our interpretation of the results in this study is that monitoring and support by VC’s lower this mortality rate.¹² To the extent that young high-tech companies are an ex-ante positive NPV investment, this constitutes a contribution of the VC industry to economic growth.

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¹² Some alternative explanations for our findings are possible. For example, VC funds may select firms with high survival rates that do not offer higher stock returns or accounting profitability if they make it to the IPO stage. If this is the case, it may be possible to argue that the VC industry contributes nothing at all – it only identifies firms that would have survived in any case. Our main point, however, remains valid: to the extent that VC funds do contribute to economic growth, they are likely to do so in reducing mortality rates, rather than in picking winners. The interpretation we offer implies that VC funds reduce mortality rates among client firms of all types, not just among the very best (or worst) companies. This is quite likely, because ranking new companies in innovative fields may be extremely difficult.

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Table 1**Industrial Organization of the VC Industry over Time: Basic Statistics**

| | 1997 | 2000 | 2002 |
|--|-------------|-------------|-------------|
| Number of VC funds | 58 | 101 | 135 |
| Total amount of capital managed by VC funds (million \$) | 1,674.7 | 5,084 | 10,575 |
| The share of capital managed by the 5 largest funds (%) | 36.2 | 24.8 | 27.1 |
| The share of capital managed by the 10 largest funds (%) | 51.0 | 36.3 | 37.7 |
| Herfindahl Index | 0.039 | 0.027 | 0.025 |
| Number of new funds | - | 63 | 48 |
| Number of closed funds | - | 20 | 14 |

Table 2

The sample in both panels of consists of the entire population of companies included in the portfolios of VC funds and other investment companies at any time between 1997 and 2000. Age and the number of employees refer to the year 2000.

Panel A: High-tech Firms in the Portfolios of VC Funds and Non-VC Investment Companies

| | VC funds | Non-VC Investment Companies |
|-------------------------------------|-----------------|------------------------------------|
| Firms in Portfolio | 492 | 169 |
| Average Age | 7.9 | 7.1 |
| Median Age | 7.0 | 5.0 |
| No. of employees (avg.) | 63.8 | 146.6 |
| No. of employees (median) | 30.0 | 20.0 |
| <u>Distribution by Industry (%)</u> | | |
| Software and Computers | 38% | 49% |
| Communication | 22% | 18% |
| Other Technology | 15% | 16% |
| Healthcare and Life Science | 21% | 12% |
| Other Non-Technology | 3% | 5% |

Panel B: Probit Regressions: Who is Included in the Portfolio of VC Funds?

The dependent variable takes the value one if a firm received VC finance and zero if a firm was financed otherwise. The omitted industry is “non-technological industries.” Standard errors appear in parentheses. ** and * denote statistical significance at the 5 and 10 percent levels, respectively.

| | VC |
|-----------------------------|------------------|
| Constant | Yes |
| Age | 0.02** (0.01) |
| Software and Computers | 0.24 (0.27) |
| Communication | 0.50* (0.28) |
| Other Technology | 0.27 (0.28) |
| Healthcare and Life Science | 0.70** (0.29) |
| McFadden’s R-squared | 0.02 |
| N | 661 |

Table 3
Changes in the Portfolios of VC Funds and Other Investment Companies
1997 - 2002

Panel A: Firms Deleted from the Portfolio

| | VC funds | Non-VC Investment Companies |
|--|---------------------|--|
| Deleted from the portfolio (% relative to the total number of firms included in the portfolio at any time between 1997 and 2000) | 26.0% (127 Obs.) | 49% (83 Obs.) |
| Average age | 7.6 | 7.3 |
| Median age | 6.0 | 5.0 |
| No. of employees (avg.) | 45.9 | 82.7 |
| No. of employees (median) | 20.4 | 15.0 |
| <u>Distribution of deleted firms by industry (%)</u> | | |
| Software and Computers | 49% | 49% |
| Communication | 21% | 18% |
| Other Technology | 9% | 13% |
| Healthcare and Life Science | 18% | 10% |
| Other Non-Technology | 4% | 10% |

Panel B: Probit Regressions Estimating the Survival Rates

VC-backed and Other High-tech Firms

The sample in this panel consists of the entire population of innovative companies included in the portfolios of VC funds and non-VC investment companies at any time between 1997 and 2000. The first three columns display probit regressions: The dependent variable “FAIL” takes the value one if a firm failed (was deleted from the portfolio) by 2002, and zero otherwise. The dependent variable EXIT takes the value one if a firm has made an exit during the same 1997-2002 period (IPO, sale, or merger), and zero otherwise. VC reputation is measured as the percent of companies in the VC’s portfolio that have made an exit, and this variable is averaged across all VC funds that financed the company and equals zero for non-VC backed firms (see also footnote 5). The last column displays an ordered probit regression, where the dependent variable equals zero if the company failed, one if it is still in the VC’s portfolio (and no form of exit has taken place), and two if the firm has made an exit. In all regressions, VC equals one for VC-backed companies, AGE is years from foundation, and the omitted sector is “non-technological industries.” Standard errors appear in parentheses. ** and * denote statistical significance at the 5 and 10 percent levels, respectively.

| | FAIL | EXIT | EXIT | Ordered Probit |
|---|-------------------|------------------|------------------|-----------------------|
| | (1) | (2) | (3) | (4) |
| Constant | Yes | Yes | Yes | N/A |
| VC | -0.62** (0.11) | 1.48** (0.31) | 1.50** (0.32) | 0.64** (0.10) |
| VC Reputation | | | -0.10 (0.67) | |
| Age | -0.003 (0.009) | 0.14** (0.02) | 0.14** (0.02) | 0.04** (0.01) |
| Software and Computers | -0.45* (0.27) | 0.65 (0.54) | 0.65 (0.54) | 0.46 (0.24) |
| Communication | -0.64** (0.28) | 1.00* (0.56) | 1.00* (0.56) | 0.67** (0.25) |
| Other Technology | -0.83** (0.29) | 0.32 (0.57) | 0.32 (0.59) | 0.57** (0.26) |
| Healthcare and Life Sciences | -0.70** (0.29) | -0.43 (0.59) | -0.43 (0.59) | 0.36 (0.26) |
| McFadden’s R-squared for columns 1-3; LR index (Pseudo R-squared) for column 4 | 0.053 | 0.14 | 0.14 | 0.054 |
| N | 661 | 661 | 661 | 661 |

Table 4**Initial Valuation Regressions**

OLS regressions, where the dependent variable is the initial valuation (market value at the end of the first day of trading). Data on pre-IPO assets is available for 75 of the 89 IPO's in our sample. VC equals one for VC-backed companies. The omitted sector is "non-technological industries." Robust standard errors appear in parentheses. ** and * denote statistical significance at the 5 and 10 percent levels, respectively.

| | Initial Valuation | Initial Valuation |
|-----------------------------|--------------------------|--------------------------|
| Constant | Yes | Yes |
| VC | 0.85 (10.75) | -2.50 (10.58) |
| Age at the time of IPO | -2.17 (1.73) | -1.94 (1.74) |
| Pre-IPO Assets | 0.55** (0.26) | 0.53** (0.26) |
| Dummy for 1996-00 IPO's | 36.98** (13.58) | 33.97** (12.79) |
| Software and Computers | | -1.39 (17.32) |
| Communication | | 21.73 (20.37) |
| Other Technology | | -4.62 (22.20) |
| Healthcare and Life Science | | -8.56 (22.32) |
| R-squared | 0.47 | 0.48 |
| N | 75 | 75 |

Table 5

**Long-run Post-IPO Stock Returns for VC-backed and Other IPO's
 "Buy and Hold" Cumulative Excess Returns over the NASDAQ Index
 Means and Medians for the Whole Sample**

Number of observations for each month: VC-backed = 51, Non-VC-backed=38. None of the differences in medians or means is statistically significant at levels of 5 percent or less.

| Month from IPO | Median | | | Mean | | |
|-------------------|--------|--------|----------------------------|-------|-------|----------------------------|
| | VC=1 | VC=0 | Significant difference? | VC=1 | VC=0 | Significant difference? |
| 1 | -5.8 | -0.8 | No | 1.7 | 3.9 | No |
| 2 | -2.0 | -0.9 | No | 1.1 | 3.2 | No |
| 3 | -5.3 | -0.7 | No | 4.5 | 9.3 | No |
| 4 | -3.3 | -8.8 | No | 4.8 | 2.5 | No |
| 5 | -4.4 | -9.5 | No | 4.1 | 3.8 | No |
| 6 | -18.6 | -12.3 | No | -3.6 | 2.1 | No |
| 7 | -22.9 | -12.6 | No | -0.6 | -1.0 | No |
| 8 | -22.8 | -12.6 | No | -0.4 | -5.5 | No |
| 9 | -24.6 | -16.8 | No | -3.8 | -9.6 | No |
| 10 | -29.7 | -10.0 | No | -2.4 | -6.8 | No |
| 11 | -26.4 | -20.7 | No | -2.4 | -12.5 | No |
| 12 | -25.6 | -25.0 | No | -9.5 | -15.4 | No |
| 13 | -30.7 | -28.5 | No | -7.3 | -12.7 | No |
| 14 | -31.4 | -34.5 | No | -7.0 | -11.8 | No |
| 15 | -34.4 | -42.7 | No | -10.8 | -15.6 | No |
| 16 | -35.7 | -38.2 | No | -12.5 | -23.1 | No |
| 17 | -29.0 | -52.5 | No | -8.4 | -29.0 | No |
| 18 | -32.2 | -65.3 | No | 2.6 | -31.8 | No |
| 19 | -29.7 | -63.0 | No | -0.2 | -34.5 | No |
| 20 | -34.7 | -62.8 | No | -21.2 | -32.3 | No |
| 21 | -44.8 | -66.2 | No | -18.9 | -38.2 | No |
| 22 | -39.1 | -64.5 | No | -24.5 | -41.0 | No |
| 23 | -47.9 | -63.2 | No | -23.6 | -44.6 | No |
| 24 | -53.7 | -79.1 | No | -40.2 | -44.7 | No |
| 25 | -59.8 | -72.2 | No | -45.0 | -52.9 | No |
| 26 | -56.6 | -82.4 | No | -49.2 | -51.4 | No |
| 27 | -60.3 | -91.2 | No | -58.0 | -61.1 | No |
| 28 | -65.3 | -92.4 | No | -62.4 | -70.1 | No |
| 29 | -71.2 | -99.1 | No | -64.6 | -77.5 | No |
| 30 | -74.4 | -89.1 | No | -61.4 | -76.3 | No |
| 31 | -75.6 | -91.8 | No | -60.6 | -73.1 | No |
| 32 | -67.3 | -106.3 | No | -66.1 | -77.5 | No |
| 33 | -77.6 | -97.4 | No | -71.2 | -87.7 | No |
| 34 | -68.2 | -104.0 | No | -71.1 | -91.7 | No |
| 35 | -82.0 | -104.2 | No | -74.3 | -91.2 | No |
| 36 | -69.3 | -102.2 | No | -71.3 | -93.6 | No |

Table 6**Cross-sectional Excess Returns Regressions**

OLS regressions, where the dependent variable is cumulative “buy and hold” abnormal returns for 36 months. VC equals one for VC-backed companies. The propensity score is based on the Exit probit in Table 3B. The omitted sector is “non-technological industries.” Robust standard errors appear in parentheses. The sample size varies because of one missing observation on age and several missing observations on pre-IPO assets. ** and * denote statistical significance at the 5 and 10 percent levels, respectively.

| | Cumulative Buy and Hold Abnormal Returns | Cumulative Buy and Hold Abnormal Returns | Cumulative Buy and Hold Abnormal Returns | Cumulative Buy and Hold Abnormal Returns |
|-----------------------------|---|---|---|---|
| Constant | Yes | Yes | Yes | Yes |
| VC | 13.64 (25.72) | 13.67 (25.44) | 13.38 (24.29) | 8.94 (29.21) |
| Age at the time of IPO | | -0.35 (1.11) | -0.42 (1.17) | |
| Pre-IPO Assets | | | 0.08 (0.15) | |
| Propensity Score | | | | 224.83 (290.79) |
| Dummy for 1996-00 IPO's | -36.47 (28.21) | -35.15 (28.11) | -24.03 (23.03) | -33.95 (28.86) |
| Software and Computers | 68.67** (24.06) | 66.60** (26.11) | 72.60** (28.73) | 64.98** (23.54) |
| Communication | 104.93** (27.45) | 106.47** (29.84) | 79.64** (22.72) | 106.30** (28.42) |
| Other Technology | 22.54 (27.59) | 23.03 (27.17) | 12.92 (29.04) | 23.56 (26.73) |
| Healthcare and Life Science | -35.51 (32.90) | -36.90 (31.73) | -18.16 (35.17) | -27.80 (40.85) |
| R-squared | 0.18 | 0.18 | 0.17 | 0.19 |
| N | 89 | 88 | 75 | 88 |

Table 7**Accounting Measures of Post-issue Performance**

Mean values of post-IPO accounting profitability and asset growth rates for VC-backed and other companies. The sample size varies because of missing accounting data.

| | VC=1 | VC=0 | Is the difference between VC and non-VC significant at the 5% level? |
|--|-------------|-------------|---|
| Operating profits to assets (one year after the IPO, N=65) | -4.6% | 4.3% | No |
| Net profits to assets (one year after the IPO, N=68) | -8.6% | -2.4% | No |
| Pre-tax profits to assets (one year after the IPO, N=68) | -10.3% | -26.5% | No |
| Average asset growth three years after the IPO (N=54) | 69% | 33% | No |

Figure 1

Mean Post-IPO Stock Returns for VC-backed and Other IPO's
"Buy and Hold" Excess Returns over the NASDAQ Index

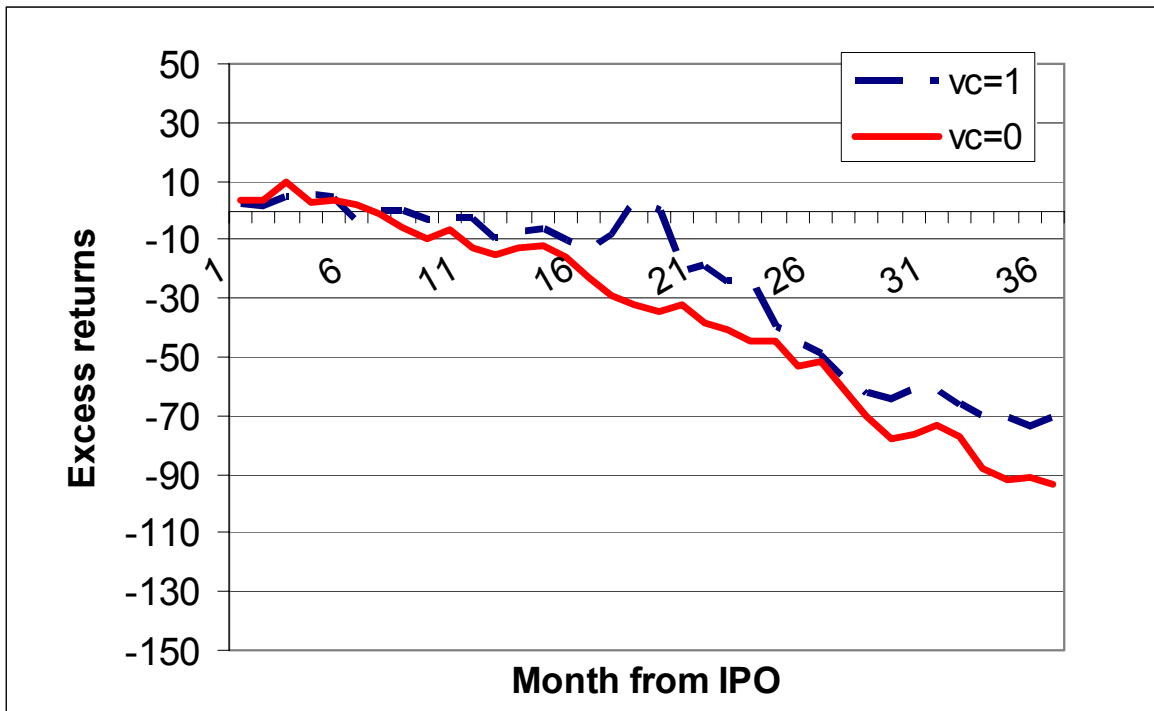


Figure 2: Bootstrapping the Distribution of the Difference in Mean CAR between VC-backed and Other IPO's (1000 Draws with Replacement)

Distribution of difference of means (VC - non-VC), observed value = 22.3

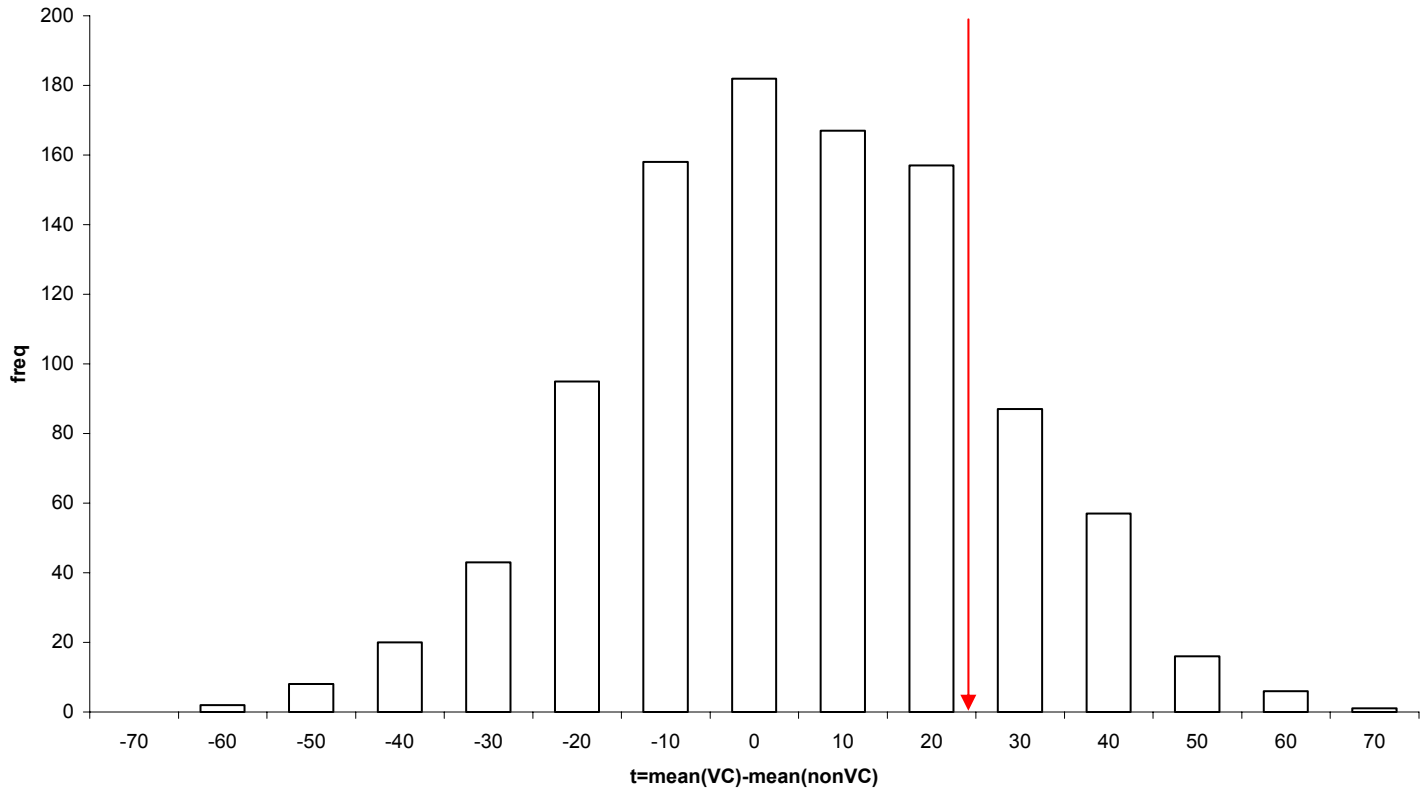


Figure 3

Mean Post-IPO Stock Returns for VC-backed and Other IPO's by Cohorts
1991-1995

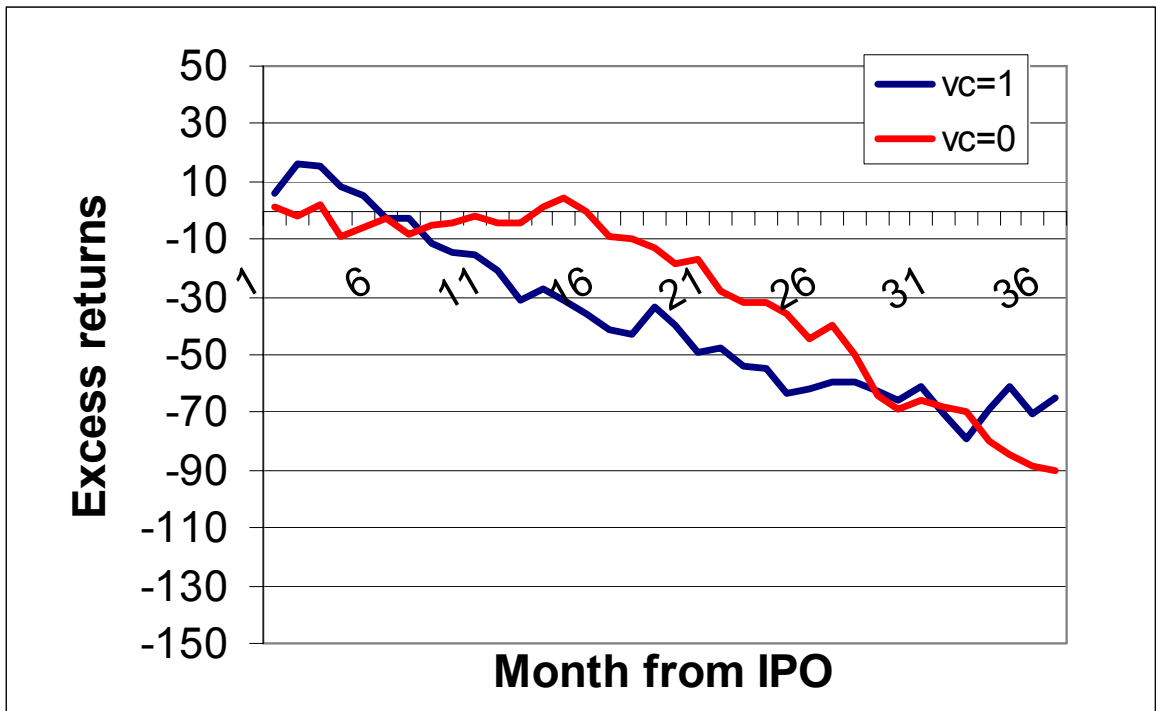


Figure 3, Continued:
Mean Post-IPO Stock Returns for VC-backed and Other IPO's by Cohorts
1996-2000

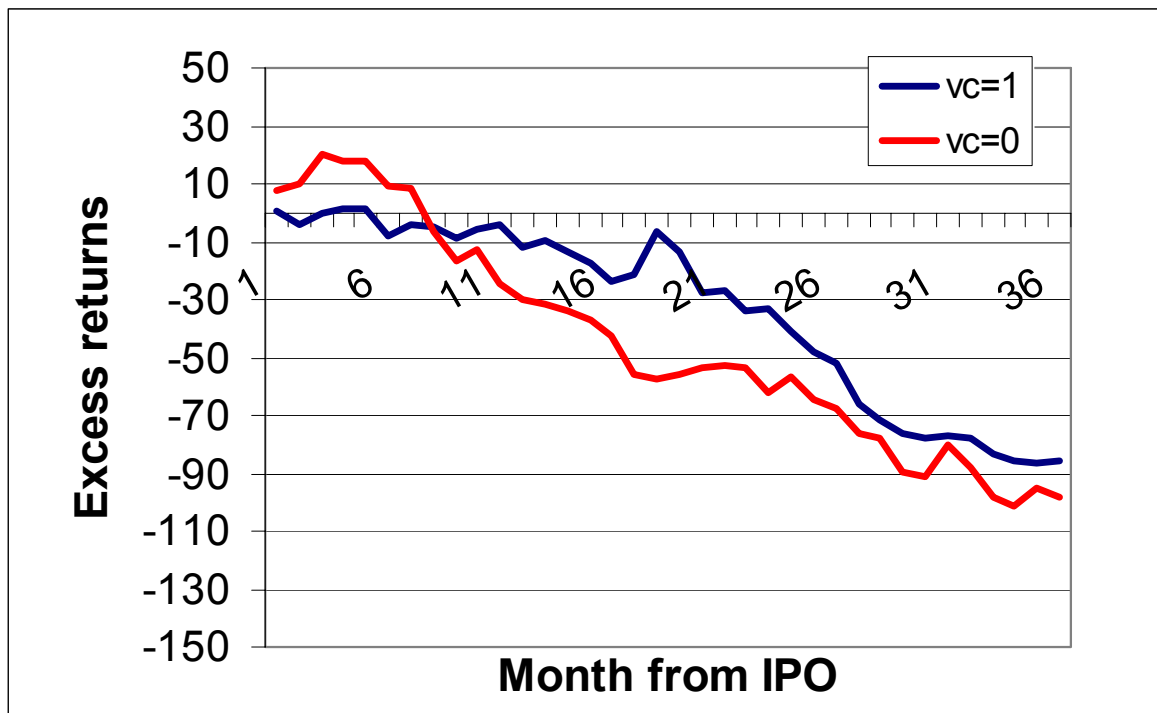
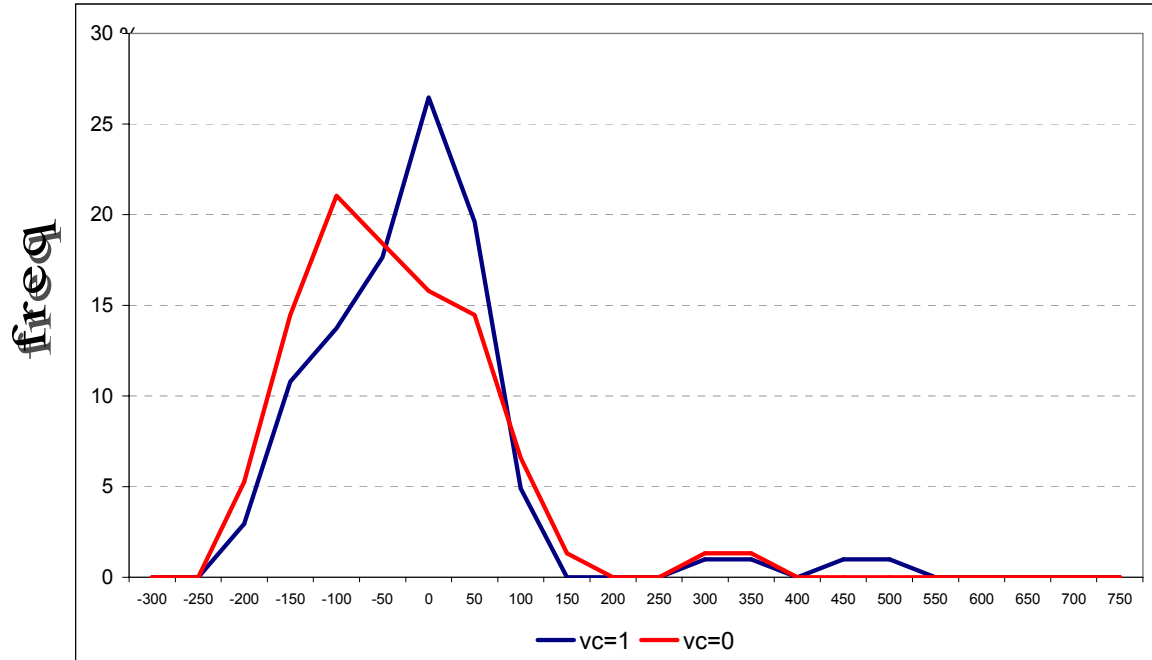


Figure 4
The Distribution of 36 month “Buy and Hold”
CAR’s among VC-backed and Other IPO’s



**Appendix: Alternative Calculation of Long-run Post-IPO Stock Returns with
Monthly Re-balancing (see text)**

Number of observations for each month: VC-backed = 51, Non-VC-backed=38. None of the differences in medians or means is statistically significant at levels of 5 percent or less.

| Month from IPO | Median | | | Mean | | |
|-------------------|--------|--------|----------------------------|-------|-------|----------------------------|
| | VC=1 | VC=0 | Significant difference? | VC=1 | VC=0 | Significant difference? |
| 1 | -5.8 | -0.8 | No | 1.7 | 3.9 | No |
| 2 | -6.7 | -3.7 | No | 3.3 | 3.8 | No |
| 3 | -7.0 | -2.1 | No | 7.0 | 8.5 | No |
| 4 | -10.4 | -9.6 | No | 8.0 | 1.3 | No |
| 5 | -13.0 | -13.9 | No | 6.5 | 2.4 | No |
| 6 | -22.5 | -17.5 | No | 1.1 | 0.0 | No |
| 7 | -22.9 | -17.1 | No | 3.8 | 0.2 | No |
| 8 | -27.2 | -19.9 | No | 5.3 | -3.4 | No |
| 9 | -29.4 | -24.0 | No | 4.7 | -6.1 | No |
| 10 | -31.8 | -23.0 | No | 6.7 | -3.4 | No |
| 11 | -33.7 | -28.7 | No | 7.1 | -10.0 | No |
| 12 | -40.6 | -34.1 | No | 2.2 | -15.4 | No |
| 13 | -41.2 | -36.8 | No | 1.3 | -16.3 | No |
| 14 | -44.9 | -40.1 | No | 1.5 | -16.8 | No |
| 15 | -47.8 | -41.8 | No | -1.5 | -21.2 | No |
| 16 | -52.4 | -49.7 | No | -5.4 | -30.1 | No |
| 17 | -52.7 | -59.9 | No | -2.7 | -41.5 | No |
| 18 | -57.2 | -59.6 | No | -1.5 | -30.7 | No |
| 19 | -63.3 | -61.7 | No | -3.4 | -32.2 | No |
| 20 | -63.6 | -64.3 | No | -6.4 | -28.0 | No |
| 21 | -65.1 | -71.6 | No | -7.3 | -35.9 | No |
| 22 | -66.0 | -75.6 | No | -5.9 | -37.4 | No |
| 23 | -65.9 | -76.4 | No | -8.9 | -30.4 | No |
| 24 | -69.3 | -79.6 | No | -9.4 | -32.9 | No |
| 25 | -70.0 | -86.5 | No | -10.6 | -35.8 | No |
| 26 | -68.0 | -89.8 | No | -5.8 | -34.5 | No |
| 27 | -72.1 | -97.2 | No | -10.7 | -39.0 | No |
| 28 | -71.8 | -97.9 | No | -8.4 | -27.8 | No |
| 29 | -71.3 | -104.6 | No | -7.4 | -29.1 | No |
| 30 | -71.2 | -103.8 | No | -4.6 | -15.3 | No |
| 31 | -75.6 | -112.7 | No | -4.8 | -5.2 | No |
| 32 | -79.0 | -111.9 | No | -7.6 | -0.9 | No |
| 33 | -83.6 | -114.4 | No | -8.1 | 0.9 | No |
| 34 | -85.2 | -121.8 | No | -1.3 | -6.4 | No |
| 35 | -87.0 | -124.0 | No | -2.2 | 4.8 | No |
| 36 | -87.5 | -125.0 | No | -3.6 | 6.0 | No |

Working and Position Papers

- 1) Lach, S., "Do R&D Subsidies Stimulate or Displace Private R&D? Evidence from Israel", Science, Technology and the Economy Program (STE) – Working Papers Series, March 2001.
- 2) Trajtenberg, M., "R&D Policy in Israel: An Overview and Reassessment", Science, Technology and the Economy Program (STE) – Working Papers Series, March 2001.
- 3) Lichtenberg, F. R., "Sources of U.S. Longevity Increase, 1960-1997", Science, Technology and the Economy Program (STE) - Working Papers Series, November 2000.
- 4) Peled, D., "Defense R&D and Economic Growth in Israel: A Research Agenda", Science, Technology and the Economy Program (STE) - Working Papers Series, March 2001.
- 5) Trajtenberg, M., "Innovation in Israel 1968-1997: A Comparative Analysis using Patent Data", Science, Technology and the Economy Program (STE) - Working Papers Series, 2001.
- 6) Silipo, D.B. and Weiss, A., "Cooperation and Competition in R&D with Uncertainty & Spillovers", Science, Technology and the Economy Program (STE) - Working Papers Series, August 2001.
- 7) Lach, S. and Sauer, R.M., "R&D, Subsidies and Productivity", Science, Technology and the Economy Program (STE) - Working Papers Series, September 2001.
- 8) Bizan, O., "The Determinants of Success of R&D Projects: Evidence from American-Israeli Research Alliances", Science, Technology and the Economy Program (STE) - Working Papers Series, September 2001.
- 9) Ber, H., "Is Venture Capital Special? Empirical Evidence from a Government Initiated Venture Capital Market", Science, Technology and the Economy Program (STE) - Working Papers Series, February 2002.
- 10) Blass, A. and Yosha, O., "Financing R&D in Mature Companies: An Empirical Analysis", Science, Technology and the Economy Program (STE) - Working Papers Series, April 2002.

- 11) Breznitz, D., "Conceiving New Industrial Systems: The Different Emergence Paths of the High-Technology Industry in Israel and Ireland", Science, Technology and the Economy Program (STE) - Working Papers Series, May 2002.
- 12) Gandal, N. "A First Look at Internet Business Methods Patents", Science, Technology and the Economy Program (STE) - Working Papers Series, May 2002.
- 13) Breznitz, D., "The Military as a Public Space—The Role of the IDF in the Israeli Software Innovation System", Science, Technology and the Economy Program (STE) - Working Papers Series, May 2002.
- 14) Bar-Eliezer, S. and A. Bregman, "The Impact of Research and Development Spillover on Growth and Productivity in Israeli Manufacturing Industries 1990–1994", Science, Technology and the Economy Program (STE) - Working Papers Series, September 2002.
- 15) Shaked, A., "Universal Banking and Investment in R&D Intensive Firms—An Empirical Investigation", Science, Technology and the Economy Program (STE) - Working Papers Series, September 2002.
- 16) Bental, B. and D. Peled, "Quantitative Growth Effects of Subsidies in a Search Theoretic R&D Model", Science, Technology and the Economy Program (STE) - Working Papers Series, October 2002.
- 17) Dan Galai and Zvi Wiener, "A Micro-Economic Approach to Government Support of R&D Investments in the Private Sector", Science, Technology and the Economy Program (STE) - Working Papers Series, November 2002.
- 18) Lach S., Schankerman M., "Incentives and Invention in Universities", Science, Technology and The Economy Program (STE) Working Papers Series STE-WP-18-2003, May 2003.
- 19) Miron E., Erez M., Naveh E., "Do Personal Characteristics and Cultural Values that Promote Innovation, Quality, and Efficiency Compete or Complement Each Other?", Science, Technology and The Economy Program (STE) Working Papers Series STE-WP-19-2003, June 2003.
- 20) Avnimelech, Gil and Morris Teubal, "Evolutionary Venture Capital Policies: Insights from a Product Life Cycle Analysis of Israel's Venture

Capital Industry", Science, Technology and The Economy Program (STE) Working Papers Series STE-WP-20-2003, November 2003.

- 21) Breznitz, Dan, "Innovation and the Limits of State's Power: R&D and Industrial Policy in Taiwan in IC Design and Software", Science, Technology and The Economy Program (STE) Working Papers Series STE-WP-21-2004, April 2004.
- 22) Cohen-Goldner, Sarit and Zvi Eckstein, "Immigrants in the Hi-Tech Sector: Comparison to Natives and the Effect of Training", Science, Technology and The Economy Program (STE) Working Papers Series STE-WP-22-2004, October 2004.
- 23) Ber, Hedva and Yishay Yafeh, "Can Venture Capital Funds Pick Winners? Evidence from Pre-IPO Survival Rates and Post-IPO Performance", Science, Technology and The Economy Program (STE) Working Papers Series STE-WP-23-2004, October 2004.