

# Managerial Factors and Management Conflict in Venture Capital Financing in Malaysia

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## Abstract

The warm venture cooperation built between venture capitalists and entrepreneurs may still be interrupted by the management's conflicts occurred due to various managerial factors. As a result, this study investigates the management conflict in venture capital investments. A cross-sectional study of questionnaire survey research design was conducted in this respect. Questionnaire data was generated from 35 Malaysian venture capital companies located in Kuala Lumpur and Selangor. The questionnaires were distributed through the mailing procedure. Overall, the findings indicate that the managerial factors significantly influence the management conflict. Further results show that managerial factors which consist of Deal Origination and Screening (DOS), Evaluating Venture Proposal (EVP), Contracting and Deal Structuring (CDS), Monitoring and Post Investment Activities (MPI) and Risk Management (RM) significantly influence the formation of management conflict in venture cooperation. Based on the findings, it is inferred that managerial factors does influence the occurrence of management conflict in venture cooperation. Thus, the study recommends that Malaysian venture capitalists give consideration to the managerial factors in reducing or curbing the possibility of conflict to occur.

**Keywords:** venture capital, management conflict, venture cooperation, entrepreneurs, venture capitalist

## 1. Introduction

The ultimate goal in any venture cooperation is to create a successful venture business. The likelihood of a venture cooperation to success is also depends on the venture capitalists' ability to establish cordial relationships with the entrepreneurs (Lim et al., 2013). The challenges and the difficulties faced by venture capitalists in managing venture business have made it mandatory for them to develop good and strong relationships with each other to achieve mutual goals (Gimmon et al., 2011; Jääskeläinen, 2011; Sohaimi, 2004). However, the warm venture cooperation built between venture capitalists and entrepreneurs may still be interrupted by management conflict as highlighted by Yitshaki (2008) and Sohaimi (2004). As management conflict may negatively affect the performance of the venture businesses (Vanacker et al., 2013), it may also become one of the major barriers that prevent both venture capitalists and entrepreneurs from creating successful venture business.

In the absence of perfect foresight, the venture capitalists face the prospect of incomplete compliance by the investee firms (Gimmon et al., 2011; Wendels et al., 2011). In other words, the venture capitalists can only judge the effectiveness within which the investee firms complete their assigned tasks in an indirect way. Typically, the investee firms are not fully supervised and they have a measure of independence which tempts them to exploit the trust, i.e. by avoiding the risk and to shirk on effort. In this view, the venture capitalists may be worried about the possible action of the investee firms, and thus may work toward precaution strategies and direct management involvement (Park & Steensma, 2012; Yitshaki, 2008). Moreover, this may lead toward positive instead of artificial business scenario. In addition, where informational asymmetries are significant among them, the investee firms are tempted to defect from the financial contracts because it is quite easy to manipulate strategic information to the venture capitalists about their venture businesses to their short-term ends (Minai et al., 2011; Miller & Wesley, 2010).

It is argued here that the root for any management conflict in any venture capital cooperation is presumed to come from the investee firms themselves rather than from the venture capitalists. The conflict in venture

cooperation exists largely during the post investment stage mainly due to the failure of the investee firms in fulfilling their obligations (Andrieu, 2013; Metrick & Yasuda, 2010) in particular, by having full information disclosure, even though the requirement for this is clearly specified in the contractual agreement. The presumption that the conflict in venture capital cooperation originated from the investee firms behaviour is confirmed by many venture capital literatures and this is quite hard to be denied (Andrieu, 2013; Gimmon et al., 2011; Metrick & Yasuda, 2011; Yitshaki, 2008; Sohaimi, 2004). This has raised the major questions for this study, what are the major factors that contribute to the occurrence of management conflict between the venture capitalists and their investee firms in their venture cooperation? In the light of above, this paper examines the determinants of management conflict between the Malaysian venture capitalists and the entrepreneurs being funded by them (investee firms) in their venture cooperation.

## 2. Literature Review

Venture capitalists are known as one of the main risk capital providers that offer financing to the potential firms that have sound business ideas but lack of capital to materialize them. They act as a financial intermediary between fund providers that seek high returns and entrepreneurs who are in need for capital financing. Their financing involves six sequential processes, at pre investment stage: i) deal origination and screening, ii) evaluating venture proposal, iii) contracting and deal structuring, and at post investment stage, iv) monitoring and post investment activities, v) acquiring liquidity and vi) risk management (Groh & Liechtenstein, 2011; Yitshaki, 2008; Klonowski, 2007; Sohaimi, 2004).

These thorough processes imply that due to the high risk of their investment in investee firms, the venture capitalists have to be cautious and strategic in their investment. Unlike conventional investors, venture capitalists contribute more than just money to their invested venture businesses and they are very selective towards certain industries. These are part of their endeavor in minimizing the potential of an unfavorable scenario such as facing disastrous conflict which may result in the failure of their investment.

Conflict is defined as the interaction of interdependent people who perceive opposition of goals, aims, and values, and who see the other party as potentially interfering with the realization of these goals. Basically, conflicts occur due to a variety of factors. Individual differences in goals, expectations, values, proposed courses of action and suggestions about how to best handle a situation are unavoidable (Speakman and Ryals, 2010). Therefore, when these differences are gathered together, the unease feeling by each party involved will lead to the occurrence of conflict.

Theoretically, conflicts arise from opposing interests involving scarce resources and goal divergence and frustration (Avgar, 2010; Speakman & Ryals, 2010; Tjosvold, 2006). Conflict is the condition in which the needs or desires of two or more parties appear to be incompatible (Montes et al., 2012). It is the competition between interdependent parties who perceive that they have incompatible needs, goals, desires, or ideas and a situation in which people cannot agree or create harmony with one another (Parayitam et al., 2010).

In the case of venture capital cooperation, management conflict is the conflicts experienced by the venture capitalists with their investee firms in managing together their venture business. This term covers agency conflicts or problems that are impossible to fully contract away by both parties.

The negative consequences of management conflict are well recognized in the literature. The destructive nature of conflict described in the literature strongly suggests that conflict is to be reduced or mitigated. Conflict is documented to arise from opposing interests involving scarce resources and goal divergence and frustration (Tjosvold, 2006). It is the condition in which the needs or desires of two or more parties appear to be incompatible (Montes, 2012).

In venture capital cooperation, the conflict between venture capitalists and entrepreneurs negatively affect the venture outcomes (Gimmon et al., 2011; Minai & Lucky, 2011; Yitshaki, 2008; Sohaimi, 2004; Higashide & Birley, 2002). Thus, many studies have highlighted the importance of developing cordial relationship between them in increasing the opportunity of the venture to yield positive outcomes. These studies on the relationship between venture capitalists and entrepreneurs include the venture capital investment duration (Cumming & Johan, 2010), the inherent and actual conflicts between venture capitalists and venture backed firms (Yitshaki, 2008), management conflict in venture capital financing in the Malaysian Information, Communication and Technology (ICT) sector (Sohaimi, 2004), the cognitive conflict (Higashide & Birley, 2002), the incentives to exit (Collewaert, 2012; Bienz & Walz, 2010), the exchanging of information and strategic information (Reid, 1998; Wright & Robbie, 1996), active monitoring (Gompers, 2012; Hellmann, 1998; Timmons & Bygrave, 1986), the proper syndicating of financing (Fritsch & Schilder, 2012; Jääskeläinen, 2012; Admati & Pfleiderer, 1994), the staging of actual financing (Gompers, 1995; Sahlman, 1990) and the screening mechanisms employed

(Knockaert et al., 2010; Franke et al., 2008; MacMillan et al., 1987).

While such an emphasis is important, it does modestly to shed light on the complementary role of managerial factors in contributing to the occurrence of conflict between venture capitalists and entrepreneurs in venture cooperation. It is important to understand the managerial factors, whereby the nature of management conflict between venture capitalists and entrepreneurs is a consequence of their characteristics.

For instance, Sohaimi (2004) in his study on the management conflict between Malaysian venture capitalists and their investee firms found that the monitoring and post investment activities, risk management and acquiring liquidity were among the factors that contribute directly to the formation of management conflict between venture capitalists and their investee firms in venture cooperation. However, the findings might not give the clear picture on the management conflict occurred in the Malaysian venture cooperation as the study only focused on the venture cooperation between Malaysian venture capitalists and entrepreneurs involved in the Malaysian ICT sector. Therefore, to overcome this limitation, this study's scope has been broadened by investigating the contributing factors in the management conflict in venture cooperation between venture capitalists and the entrepreneurs to enrich the information and literature in this area. In line with the above arguments, the following research framework has been formed to investigate the main research question.

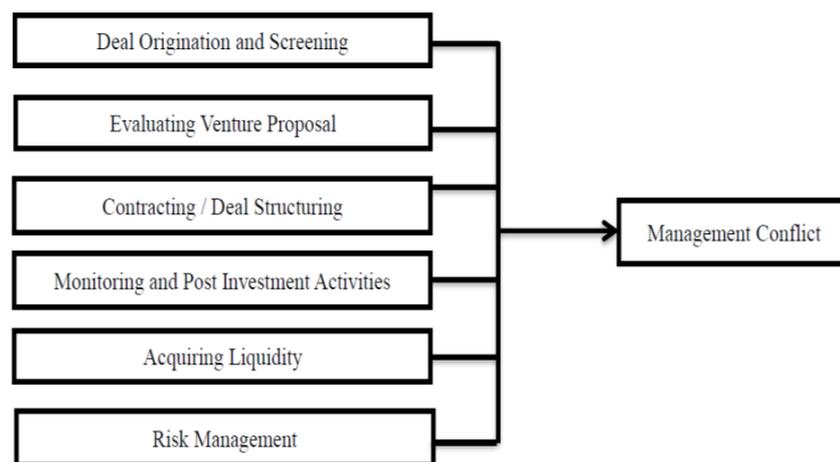


Figure 1. Research framework

### Hypotheses Development

According to Yitshaki (2008) and Sohaimi (2004), venture capital financing involves six sequential processes known as the managerial factors, namely deal origination and screening, evaluating venture proposal, contracting and deal structuring, monitoring and post investment activities, acquiring liquidity and risk management. These are the factors that should be addressed by the venture capitalists since they are significantly related to the occurrence of management conflict in any venture cooperation. For instance, poor deal and screening coupled with the weak venture evaluation may result in the venture capitalists to fund incompetent firms which may have high potential to fail or defect in venture cooperation. Also, incomprehensive deal structuring and financial contract may also create potentials for the investee firms to defect from the contract. Poor monitoring and risk management activities may result in the investee firms to not fully supervised and finally may cause the venture capitalists as principal to face the prospect of incomplete compliance by the investee firms as agent in their venture cooperation. These are the factors that have high potentials to create management conflict in venture cooperation and hence are felt justified to be studied in the research framework as the independent variables. Therefore, from the above discussions, the research framework for the study as presented in figure 1 should be acceptable.

Based on these descriptions and also coupled with the above research framework, the following hypotheses are hereby formulated:

- H<sub>1</sub>: Deal origination and screening is significantly related to management conflict.
- H<sub>2</sub>: Evaluating venture proposal is significantly related to management conflict.
- H<sub>3</sub>: Contracting and deal structuring is significantly related to management conflict.

H<sub>4</sub>: Monitoring and post investment activities is significantly related to management conflict.

H<sub>5</sub>: Acquiring liquidity is significantly related to management conflict.

H<sub>6</sub>: Risk management is significantly related to management conflict.

### **3. Methodology**

#### *3.1 Study Design*

The study is a cross sectional study of the questionnaire survey approach with a judgment sampling method where the Malaysian venture capital companies operating in Kuala Lumpur and Selangor were selected as the targeted population of this study. The sample respondents in this study comprise of venture capital investment personnel from executive level or higher in the selected venture capital companies. The venture capital companies were identified through the Malaysian Venture Capital Development Council (MVCDC) and Malaysia Venture Capital Association (MVCA) directories obtained through their website. A list of 102 venture capital companies was sorted out from the main list. However, only 49 respondents were qualified to participate in the study as the study samples. The remaining 64 respondents were found to be either inactive or inaccessible. Of these 49 potential respondents, only 44 respondents were willing to participate in the study. A total of 44 survey questionnaires were distributed through the email and post procedures. A total of 35 completed questionnaires were returned filled, thus giving 79.55% response rate from the total sample size.

#### *3.2 Measurement of Variables*

To measure the variables, the study adopted the primary data collection questionnaire survey technique to achieve its objective. The survey questionnaire consists of twenty nine (29) closed ended and eleven (11) open-ended questions which were grouped into five parts. All variables in the study were measured using a five-point Likert scale ranging from 1 = strongly disagree to 5 = strongly agree was used to measure the extent to which respondents agree or disagree to each of the statements in the questionnaire (Lucky & Minai, 2011; Minai & Lucky, 2011; Lucky & Minai, 2012).

#### *3.3 Questionnaire Description*

The independent variables (managerial factors) were measured using 93 items while the dependent variable (management conflict) was measured using 7 items. The items used in this study were adapted from the various works of authors such as Yitshaki (2008) and Sohaimi (2004). Deal Origination and Screening (DOS) was measured using 4 items while the Evaluating Venture Proposal (EVP) was measured using 36 items. 5 items were used to measure Contracting and Deal Structuring (CDS), 21 items were used to measure Monitoring and Post Investment Activities (MPI), 6 items were used to measure Acquiring Liquidity (AL) and another 21 items were used to measure Risk Management (RM). In total, there were 100 items used to measure both the independent variables and the dependent variable in this study. The data for the descriptive analysis were gathered from 22 open ended questions provided in the questionnaire.

### **4. Data Analysis and Results**

#### *4.1 Descriptive Analysis Result*

To summarize the profile of the respondents, a descriptive analysis was conducted using the SPSS version 19. The result indicates that out of the 35 respondents that participated in the study, the majority of them or 80% of the respondents were preferred to use both specific and non-contractual monitoring while another 20% of them preferred non-contractual monitoring method. The result also indicates that all the respondents, or 100% of them require their investee to prepare the periodic reports. The result also indicates that the majority of the respondents or 68.6% of them often face problems and conflict with their investee firms. Another 17.1% respondents reported that they sometimes face problems with their investee firms while the other 14.3% reported that they rarely face problems with their investee firms.

#### *4.2 PLS Estimation Results with Smart PLS*

Due to the conditions of insufficient, small sample size, explanation on endogenous construct, variance based methods and the violation of the basic assumptions, the use of Partial Least Square (PLS) becomes necessary in this study in analyzing the data (Zhang, 2009). Sharma and Kim (2012) noted that the use of PLS becomes necessary under conditions of insufficient sample size while Chin (1995) concurred that PLS is required for data analysis in a situation where there are many indicators and factors are involved. In this vain, Zhang (2009) noted that PLS can deal with both formative and reflective construct, which is the exact situation in this study. Thus, these situations reflect the present study and therefore, the study opted for the use of PLS for the data analysis.

### 4.3 Measurement Model

For the model measurement, construct validity was conducted using the smartPLS with a two-step structural equation modeling (SEM) approach by Anderson and Gerbing (1988). Based on this, the internal reliability and convergent validity for constructs were first conducted and then followed by the assessment of the discriminant validity of constructs as indicated in Table 1 and 2 respectively. For this, a minimum loading of 0.7 and above value was required for an item to be accepted for cross loadings and composite reliability as suggested by Hair et al. (2011).

The result in Table 1 indicates that only 2 items coded as CDS<sub>c</sub> and CDS<sub>d</sub> were retained for Deal Origination and Screening. 5 items coded EVP2<sub>a</sub>, EVP3ET<sub>b</sub>, EVP3MA<sub>a</sub>, EVP3PD<sub>a</sub> and EVP3PD<sub>c</sub> were also retained for Evaluating Venture Proposal. 2 items coded as CDS<sub>c</sub> and CDS<sub>d</sub> were retained for Contracting and Deal Structuring, while 2 items coded as MPI1<sub>a</sub> and MPI1<sub>e</sub> were retained for Monitoring and Post Investment activities. 5 items coded as RM1<sub>b</sub>, RM2AR<sub>c</sub>, RM2AR<sub>d</sub>, RM2MR<sub>d</sub> and RM2MR<sub>g</sub> were retained for Risk Management. 6 items coded as IAR2<sub>b</sub>, IAR2<sub>c</sub>, IAR2<sub>d</sub>, IAR2<sub>e</sub>, IAR2<sub>f</sub> and IAR2<sub>g</sub> were also retained for Management Conflict. One of the independent variables, Acquiring Liquidity and other items were excluded due to the low loadings of less than 0.70; a Composite Reliability (CR) = (square of the summation of the factor loadings)/[(square of the summation of the factor loadings) + (square of the summation of the error variances)]; b Average Variance Extracted (AVE) = (summation of the square of the factor loadings)/[(summation of the square of the factor loadings) + (summation of the error variances)].

For the average variance extracted (AVE), a minimum value of 0.5 is considered accepted (Bagozzi, et al., 1991; Chin, 1998; Fornell & Larcker, 1981; Gefen, et al., 2000) while the discriminant validity of the constructs is determined by the average variance shared between each construct and its measures should exceed the variance shared between the construct and other constructs (Fornell & Larcker 1981). Table 1 further indicates that all construct utilized in the study produced AVE values more than the suggested value of 0.5 by Bagozzi et al. (1991) and Chin (1998).

Accordingly, the result also indicates that all construct yielded factor loading more than 0.7 as suggested by (Hair et al., 2011) while the values for composite reliability also indicated 0.7 and above as suggested (Gefen et al., 2000), suggesting that the measurement model has achieved satisfactory internal reliability and convergent validity.

Table 1. Measurement model result

Latent Variables	Items	Loadings	AVE	Composite Reliability
Contracting and deal structuring	CDS <sub>c</sub>	0.873491	0.801094	0.889508
	CDS <sub>d</sub>	0.916080		
Deal origination and screening	DOS <sub>c</sub>	0.795995	0.591064	0.742732
	DOS <sub>f</sub>	0.740621		
	EVP2 <sub>a</sub>	-0.870927		
Evaluating venture proposal	EVP3ET <sub>b</sub>	0.807604	0.674948	0.355035
	EVP3MA <sub>a</sub>	-0.704151		
	EVP3PD <sub>a</sub>	0.871007		
	EVP3PD <sub>c</sub>	0.842331		
	IAR2 <sub>b</sub>	0.706685		
Management conflict	IAR2 <sub>c</sub>	0.773541	0.585676	0.894211
	IAR2 <sub>d</sub>	0.704601		
	IAR2 <sub>e</sub>	0.777776		
	IAR2 <sub>f</sub>	0.796354		
	IAR2 <sub>g</sub>	0.825051		
	Monitoring and post investment activities	MPI1 <sub>a</sub>		
MPI1 <sub>e</sub>		0.915915		
RM1 <sub>b</sub>		0.813775		
Risk management	RM2AR <sub>c</sub>	0.865786	0.701401	0.242900
	RM2AR <sub>d</sub>	0.879343		
	RM2MR <sub>d</sub>	0.857290		
	RM2MR <sub>g</sub>	0.766160		

Table 2 shows the result of the discriminant validity for all the theoretical constructs. It indicates that the correlation for each construct is less than the square root of the average variance extracted suggesting that the measurement model has achieved adequate discriminant validity (Fornell and Larcker, 1981; Hair et al. 2011).

Table 2. Discriminant validity of constructs

Latent Variables	1	2	3	4	5	6
Contracting and deal structuring	0.895039					
Deal origination and screening	0.076353	0.768807				
Evaluating venture proposal	0.447095	0.409669	0.821552			
Management conflict	0.510645	0.634348	0.674287	0.76529		
Monitoring and post investment activities	0.393784	0.615725	0.782508	0.565454	0.86774	
Risk management	0.139383	0.516538	0.338696	0.477198	0.311371	0.837497

The result of the SmartPLS structural model presented in Table 3 depicts the relationship between the exogenous and the endogenous constructs. It shows that there is a significant relationship between Contracting and Deal

Structuring (CDS) and the management conflict ( $\beta = 1.93005$ ;  $t$ -Statistics = 1.694172). Further analysis also found that there is a significant relationship between Evaluating Venture Proposal (EVP) and management conflict ( $\beta = -0.2833$ ;  $t$ -Statistics = 1.60). The Monitoring and Post Investment (MPI) activities are also found to have a significant relationship with the management conflict ( $\beta = 0.552515$ ;  $t$ -Statistics = 3.160644).

However, the result indicates that there is no significant relationship between Deal Origination and Screening (DOS) with the management conflict ( $\beta = 0.090018$ ;  $t$ -Statistics = 0.846437). Further analysis also found that there is no significant relationship between Risk Management (RM) and management conflict ( $\beta = 0.153538$ ;  $t$ -Statistics = 1.183482). The overall  $R^2$  is found to be 0.857095, which implies that the exogenous variables; deal origination and screening, evaluating venture proposal, contracting and deal structuring, monitoring and post investment activities, risk management and controlling mechanism explain 85.7% variance of the endogenous construct – management conflict.

Table 3. Path coefficients and hypotheses testing

Hypotheses	Relationship	Beta	Standard Error	t-Statistics	P-Value	Decision
H <sub>1</sub>	DOS -> MC	0.090018	0.106349	0.846437	0.000	Not supported
H <sub>2</sub>	EVP -> MC	-0.283300	0.178968	1.582961	0.005	Supported
H <sub>3</sub>	CDS -> MC	0.193005	0.113923	1.694172	0.000	Supported
H <sub>4</sub>	MPI -> MC	0.552515	0.174811	3.160644	0.000	Supported
H <sub>6</sub>	RM -> MC	0.153538	0.129734	1.183482	0.05	Not Supported

P<0.10

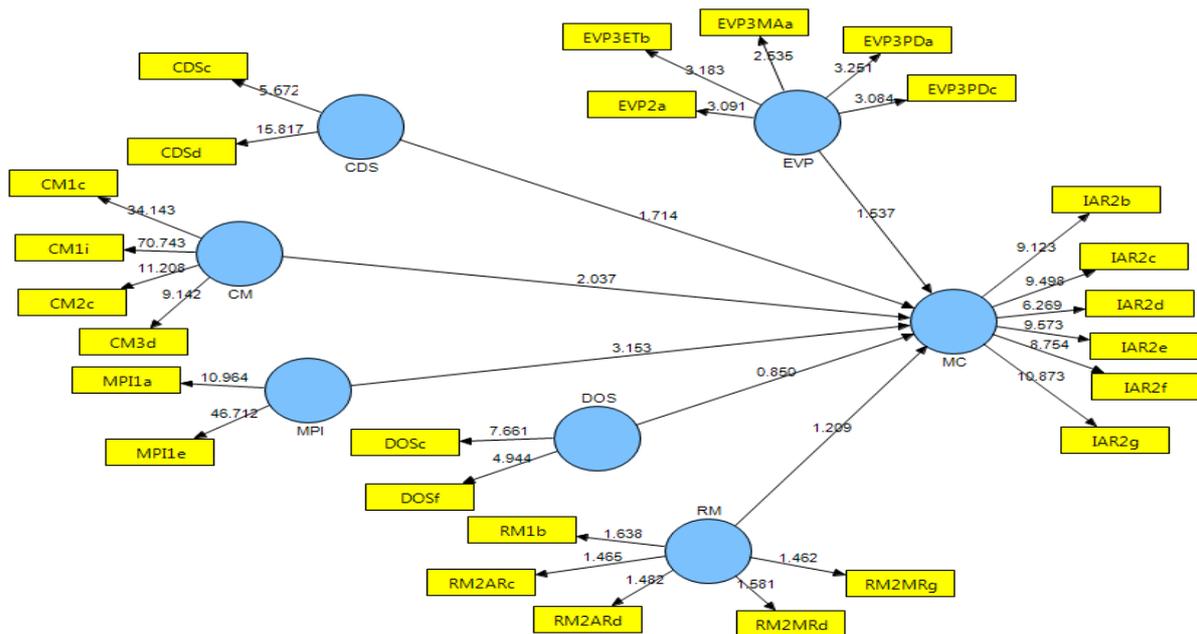


Figure 2. The direct relationship between the independent variables (deal origination and screening, evaluating venture proposal, contracting and deal structuring, monitoring and post investment evaluation and risk management) and the dependent variable (management conflict)

**5. Discussions and Conclusions**

The major objective of this study is to investigate the factors contributing to the occurrence of management conflict between the Malaysian venture capitalists and their investee firms operating in various Malaysian economic sectors as well as the resolution to solve the conflict. Therefore, the study examined the managerial factors contributing to the formation of management conflict in venture cooperation between Malaysian venture

capitalists and their investee firms in their venture cooperation. In realizing this objective, the study utilized the SmartPLS to analyze the data generated from 35 venture capital companies operating in Malaysia.

Overall, the findings demonstrated that the managerial factors such as evaluating venture proposal, contracting and deal structuring and monitoring and post investment activities significantly influence the management conflict. This result is consistent with previous studies by Sohaimi (2004) and Yitshaki (2008) who affirmed that there was a significant relationship between the managerial factors and the management conflict in venture cooperation.

The individual testing result further shows that deal origination and screening influence the management conflict, suggesting that particular independent variable is a significant factor that contributes to the occurrence of management conflict in venture cooperation. Similarly, the result also indicates that the second independent variable, evaluating venture proposal, is also influencing the management conflict. This proposes that particular independent variable is a significant factor that contributes to the occurrence of management conflict in venture cooperation. Likewise, the result shows that the third independent variable, contracting and deal structuring, influence the management conflict. Therefore, it is suggested that particular independent variable is also a significant factor that contributes to the formation of management conflict in venture cooperation. Equally, the result also points out that the fourth independent variable, monitoring and post investment activities, affect the management conflict. This suggests that particular independent variable is also a significant factor that contributes to the creation of management conflict in venture cooperation. Finally, the result demonstrates that the fifth independent variable, risk management, influence the management conflict. Hence, this suggests that specific independent variable is also a significant factor that contributes to the occurrence of management conflict in venture cooperation.

We therefore argued based on our findings that evaluation of venture proposal, contracting and deal structuring and monitoring and post investment activities are crucial in determining the occurrence of management conflict in venture cooperation. Therefore, Malaysian venture capitalists involve in the venture capital investment should address these factors if they want to minimize the opportunity for management conflict to arise between them and their investee firms in their venture cooperation. This is very critical since the cordial relationship between them and their investee firms is necessary in helping both parties to increase the opportunity for their venture cooperation to success.

The result further suggests that more focus should be given on the venture evaluation process, the contents and clauses included in the venture financial contract and deal structuring agreement and also the monitoring and post investment activities. These factors, if addressed properly will significantly help the Malaysian venture capitalists to mitigate the potential for management conflict to arise in their venture cooperation. Such strict and thorough evaluation process will help venture capitalists to choose only qualified entrepreneurs to be financed. At the other hand, a strong, clear and comprehensive contractual agreement will help Malaysian venture capitalists to exercise their rights and privileges in their venture cooperation and reduce the contractual ambiguity. Furthermore, the continuous and consistent monitoring during the post investment stage will aid the Malaysian venture capitalists to reduce the potential of any unfavorable event which have the possibility to trigger the management conflict to occur in their venture cooperation.

Without doubt, the findings obtained in this study have several implications. It has shed more insight on the need to understand the factors that contribute to the formation of management conflict in venture cooperation as well as the importance in addressing these factors towards mitigating the management conflict which can negatively affect the venture outcome. It has informed the Malaysian venture capitalists to be more focused on their investment practice with particular attention given to venture evaluation process, contractual and deal structuring and venture monitoring activities. The major limitation of this study is the data. The data for this study is limited due to the small population size of the Malaysian venture capital companies. Therefore, we recommend that this study should be replicated with a qualitative approach in other environments and research setting.

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