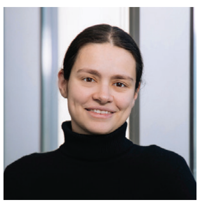
The Role of Private Equity in the Entrepreneurial Ecosystem

by Lauren Hunt, Dasha Anosova, and Yael Hochberg

ABA Antitrust Law Section (June 16, 2025)

Lauren Hunt



Dasha Anosova

Yael Hochberg

Private equity (PE) and venture capital (VC) are key inputs to innovation-driven entrepreneurship, and thus to economic growth.[1] VC supplies high-risk capital, monitoring, and governance to early-stage ventures that lack tangible collateral and face marked informational asymmetries. PE investors provide subsequent growth capital, operational discipline, and liquidity, thereby enabling promising companies to remain private for longer horizons. Well-functioning exit markets – encompassing initial public offerings (IPOs), strategic acquisitions, and secondary buyouts – complete the cycle and enable recycling of both capital and talent in the entrepreneurial ecosystem. Both PE and VC rely on active and predictable exit markets.

In this article, we discuss the role of the PE business model in fueling the entrepreneurial ecosystem. We explain how stronger exit options improve incentives of founders, employees, and investors to create new early-stage companies. We then discuss how stricter merger enforcement would lower the expected value of early stage investments, increase capital costs, and reduce entrepreneurial entry by putting this exit mechanism at risk. Understanding the dynamic incentive effects of such restrictions is therefore essential. Finally, we explore the potential consequences of stronger exit options for antitrust policy.

Role of PE in the Entrepreneurial Ecosystem

VC and PE firms are key players in the entrepreneurial ecosystem that supports innovation and economic growth. In the U.S., VC-backed companies constitute over 50 percent of IPOs on stock markets,[2] 20 percent of stock market capitalization, and 44 percent of research and development spending.[3] Industries that receive more VC funding are more likely to see subsequent increases in patenting, employment, and aggregate income.[4]

While VC investments foster growth at the earlier stages of company development, PE firms enable venture scaling by providing the necessary capital and expertise for ventures to expand operations and reach market maturity. An investment by a PE firm can allow a company to remain private for a longer period, avoiding some of the downsides of going public through an IPO or selling via an acquisition too early. In contrast to an IPO or acquisition, an investment by a PE firm often allows the company's founders to preserve decision-making control and ownership.[5] While providing an attractive exit opportunity to founders, employees, and investors, an IPO is associated not only with listing costs but also with the costs of disclosure, takeover risk, and the pressure to demonstrate short-term performance.[6]

As startups have been choosing to stay private longer,[7] PE firms have been providing not only the capital and expertise required by these later stage startups, but also an exit opportunity for the early-stage investors. An investment by a PE firm provides a way for early- and growth-stage investors to monetize their returns and return capital to their institutional investors. PE firms enable such liquidity by helping VC-funded companies achieve structured exit pathways – through secondary buyouts of early investor stakes and, occasionally, through financial acquisitions of startups from early- and growth-stage investors and founders. Secondary buyouts enable the company to continue growing as a private company, founders and employees to achieve partial liquidity and reduce personal risk exposure while retaining strategic direction, and VC funds to return capital within fund life. PE investors in startups further assist their portfolio companies with identification and facilitation of strategic acquisitions and public offerings. As the portfolio companies successfully exit, financial and human capital can be recycled into new investment opportunities.

Exit Incentives in the Entrepreneurial Ecosystem

Entrepreneurial activity is associated with a very high degree of risk. Only a small share of early-stage companies achieves a successful exit. Exit outcomes are highly skewed, with 75–91 percent of early-stage companies delivering zero exit value (i.e., yielding no financial return).[8] Only a small percentage produce large exits of the type often hyped in popular media.

Founders and employees at startups often forego stable salaries and instead agree to be compensated through the potential for their startup ownership stake to be worth a substantial amount when the company experiences a successful exit.[9] The willingness of founders and employees to take on this risk helps signal to potential investors their belief in and commitment to the high quality of the startup. Equity compensation also ensures that founders and employees are highly incentivized to exert effort to maximize the probability of success.

The risk of founder and employee compensation is further amplified by the leverage they employ to grow their businesses. Most private-company investors receive preferred shares in exchange for their investment. These preferred shares have priority in the distribution of payouts up to a predetermined amount before any remaining funds are allocated to other shareholders.[10] In contrast, founders and employees typically hold common shares with a claim on residual distributions from the company. This compensation structure incentivizes founders and employees to focus on creating value in order to enable a lucrative exit that results in payouts to the common shareholders.[11]

PE firms also have significant incentives to ensure that the startups in which they invest achieve successful exits. VC and PE firms invest funds on behalf of their limited partners (LPs) – typically institutional investors such as pension funds and endowments. The closed-end funds out of which they invest typically have limited lifespans of 10–12 years, after which capital and gains must be returned to the LPs. Because VC and PE investors in startups receive equity stakes in private, illiquid startups in return for their capital and value-added efforts, they must eventually find a way to convert that equity into liquid assets within a limited timeframe. Typically, this is done by either selling the portfolio company to a strategic or financial acquirer or taking the company public.

Better exit opportunities similarly incentivize investors to invest in risky, innovative, and new companies. When the set of feasible exit channels narrows, investors require a higher expected return to compensate for illiquidity and delayed payoff realization. The increased cost of capital reduces the net present value of marginal projects, decreasing the amount of invested capital. Suppose a VC firm is considering investing in two observably identical startups, with one startup offering an investment that could be sold to a strategic or financial acquirer and the second only allowing liquidation through an IPO, which historically has been a much less likely outcome. The VC firm would demand a premium to compensate it for investing in the startup with more limited exit options. It follows that better exit opportunities decrease the funding cost to startups and expand the set of projects that are feasible. Additionally, reduced investor lock-in resulting from better exit opportunities improves investors' ability to affect strategic decisions of the company by actual or threatened exit.[12]

Given the concentration of founder and employee compensation through exit and the need to achieve liquidity for VC and PE investors, expectations of a potential exit are critical for incentivizing entrepreneurial activity. The mere prospect of being acquired can spur more entrepreneurs to launch new ventures.[13]

Exits also generate ripple effects across the entrepreneurial ecosystem. After a company's IPO, its employees are nearly four times more likely to found or join new startups.[14] Suppliers and customers of a company going public through an IPO experience higher rates of growth in revenue compared to private companies.[15] At an aggregate level, new IPOs are associated with a 4–10 percent increase in new business registrations in the public company's geographic area.[16] High returns in the PE asset class drive future allocations to VC and PE funds that, in turn, invest in the next generation of startup companies.

Implications for Antitrust Policy

Merger analysis traditionally focuses on static product-market concentration. However, given that early-stage companies acquired by incumbents typically command negligible market share at the time of sale, the relevant competitive impact is dynamic. For example, a "killer acquisition" may enable an incumbent to extinguish a future competitive threat and maintain its market share and higher prices, potentially lowering consumer welfare. However, consumer welfare encompasses not only price, but also quality and innovative output. For instance, an acquisition can accelerate diffusion of the startup's innovation through incumbent distribution channels and, as a result, increase consumer welfare. Blanket restrictions risk treating these disparate outcomes identically.

Policies that deter acquisitions may lower the incidence of killer acquisitions but could simultaneously reduce the entry of potential innovators by removing a primary exit path. Whereas in decades past IPOs comprised the majority of successful venture-backed startup exits, they now account for only 10 percent of such exits.[17] A balanced policy would incorporate the expected reduction in future innovation into the welfare calculus.

- Beyond its impact on product pricing, merger enforcement affects consumer welfare through several channels that warrant consideration by policymakers: Effects of an acquisition on the incumbent's product quality and its incentives to innovate. An acquisition can accelerate diffusion of the startup's innovation through incumbent distribution channels.
- Availability of viable alternative exits. If IPO markets are effectively inaccessible to subscale firms, blocking an acquisition may strand investors and employees.
- Empirical estimates of how entrepreneurial activity, including VC funding, responds to decreases in exit probability. Given the importance of exits through acquisition, stricter merger enforcement can significantly impact the ability of VC investors to generate returns and, as a result, their willingness to invest.

Restrictive merger enforcement that diminishes acquisition probabilities, absent reliable substitutes, increases investor lock-in and lowers the valuations of startups, particularly in sectors reliant on intangible assets and rapid scaling. A nuanced antitrust framework that weighs dynamic innovation incentives against static concentration measures is, therefore, essential for sustaining innovation and long-run economic growth.

About the authors

Yael Hochberg serves as the Head of the Entrepreneurship Initiative and the Liu Idea Lab for Innovation and Entrepreneurship at Rice University. She holds a Research Affiliate position with MIT's Innovation Initiative and is a Research Associate at the National Bureau of Economic Research (NBER). The views expressed are those of the author and do not necessarily reflect those of Rice University, MIT, or NBER. Dasha Anosova is a Vice President and Lauren Hunt is a Managing Principal at Analysis Group. The views expressed are those of the authors and do not necessarily reflect those of Analysis Group.

Endnotes

1. Botelho, Tristan L., Daniel Fehder, and Yael Hochberg, "Innovation-Driven Entrepreneurship," NBER Working Paper No. w28990, National Bureau of Economic Research, 2021.
2. Kaplan, Steven N., and Josh Lerner, "It Ain't Broke: The Past, Present, and Future of Venture Capital," *Journal of Applied Corporate Finance*, vol. 22, no. 2, 2010, pp. 36-47.
3. Gornall, Will, and Ilya A. Strebulaev, "The Economic Impact of Venture Capital: Evidence from Public Companies," SSRN, July 2021, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2681841.
4. Kortum, Samuel, and Josh Lerner, "Assessing the Contribution of Venture Capital to Innovation," *The RAND Journal of Economics*, vol. 31, no. 4, 2000, pp. 674-92; Samila, Sampsa, and Olav Sorenson, "Venture Capital, Entrepreneurship, and Economic Growth," *The Review of Economics and Statistics*, vol. 93, no. 1, 2010, pp. 338-49.
5. Brau, James C., and Stanley E. Fawcett, "Initial Public Offerings: An Analysis of Theory and Practice," *The Journal of Finance*, vol. 61, no. 1, 2006, pp. 399-436.
6. Ewens, Michael, and Joan Farre-Mensa, "The Deregulation of the Private Equity Markets and the Decline in IPOs," *The Review of Financial Studies*, vol. 33, no. 12, 2020, pp. 5463-5509, at p. 5469.
7. Ewens, Michael, and Joan Farre-Mensa, "The Deregulation of the Private Equity Markets and the Decline in IPOs," *The Review of Financial Studies*, vol. 33, no. 12, 2020, pp. 5463-5509.

8. Ljungqvist, Alexander, and Matthew Richardson, "The Cash Flow, Return and Risk Characteristics of Private Equity," w9454, National Bureau of Economic Research, 2003; Puri, Manju, and Rebecca Zarutskie, "On the Life Cycle Dynamics of Venture-Capital– and Non-Venture-Capital-Financed Firms," *The Journal of Finance*, vol. 67, no. 6, 2012, pp. 2247–93; "Startup Genome," *The Global Startup Ecosystem Report*, 2019.

9. Hall, Robert E. and Susan E. Woodward, "The Burden of the Nondiversifiable Risk of Entrepreneurship," *American Economic Review*, June 2010, pp. 1163-1194, at p. 1163.

10. Hall, Robert E. and Susan E. Woodward, "The Burden of the Nondiversifiable Risk of Entrepreneurship," *American Economic Review*, June 2010, pp. 1163-1194, at p. 1166.

11. Hall, Robert E. and Susan E. Woodward, "The Burden of the Nondiversifiable Risk of Entrepreneurship," *American Economic Review*, June 2010, pp. 1163-1194, at pp. 1166, 1188-1189.

12. Bharath, Sreedhar T., Sudarshan Jayaraman, and Venky Nagar, "Exit as Governance: An Empirical Analysis," *The Journal of Finance*, vol. 68, no. 6, December 2013, pp. 2513–2554.

13. Fons-Rosen, Christian, Pau Roldan-Blanco and Tom Schmitz, "The Effects of Startup Acquisitions on Innovation and Economic Growth," SSRN, March 2023, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3785485.

14. Babina, Tania, Paige Ouimet and Rebecca Zarutskie, "Going Entrepreneurial? IPOs and New Firm Creation," Federal Reserve Board, 2017, at p. 2, available at https://www.federalreserve.gov/econres/feds/files/2017022pap.pdf.

15. Kutsuna, Kenji, Janet Kiholm Smith, Richard Smith, and Kazuo Yamada, "Supply-chain Spillover Effects of IPOs," *Journal of Banking and Finance*, vol. 64, 2016, pp. 150-168.

16. Barrios, John Manuel, Jung Ho Choi, Yael V. Hochberg, Jinhwan Kim, and Miao Liu, "Informing Entrepreneurs? Initial Public Offering and New Business Formation: The Role of Public Firm Disclosures," SSRN, 2023, available at https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3640736.

17. "NVCA Yearbook," NVCA, 2020.