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Escalation of commitment in venture capital decision making: Differentiating between domestic and international investors

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ABSTRACT

Drawing upon an escalation of commitment framework, this study investigates how differences between cross-border and domestic venture capital investors in emotional, social, and institutional factors affect their decision to terminate an unsuccessful investment. We track the exit outcome of 1060 venture capital investments in 684 European technology companies. Results show that domestic investors have a high tendency to escalate their commitment to a failing course of action, while cross-border investors terminate their investments efficiently, even when investing through a local branch. This is explained by cross-border investors having a lower social and emotional involvement with the project and a lower embeddedness in the local economic and social environment, decreasing individual decision biases. Further, they are affected to a lower extent by normative pressures to further invest from their co-investment network. Local branches of cross-border investors are also shielded from escalation of commitment. We conjecture that their international investment committee acts as an organizational safeguard against individual decision biases. Domestic investors may hence benefit from mimicking the behavior of cross-border investors.

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1. Executive Summary

We explore two novel related research questions. First, does the propensity of international VC investors to escalate their commitment when portfolio companies underperform differ from that of domestic VC investors? We argue that more limited emotional attachment, lower social embeddedness, and lower normative pressures faced by international VC investors reduce individual decision biases. We hypothesize that the likelihood of terminating underperforming ventures will be higher for cross-border VC investors than for domestic VC investors, as they are less emotionally and socially attached to the portfolio company and are less prone to normative pressures from their peer network. Our second question addresses whether escalation of commitment differs depending on internationalization mode. Establishment of a local branch office is widely used to mitigate the frictions associated with geographic and cultural distance. We hypothesize that the likelihood of terminating underperforming ventures will be higher for international VC investors investing from headquarters than for international VC investors investing through a local branch. We also hypothesize that the likelihood of terminating underperforming ventures will be higher for international VC investors investing through a local branch than for domestic VC investors.

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To test our hypotheses, we use a unique hand-collected sample of technology based companies from seven European countries. The sample contains longitudinal data on 1618 unique rounds of VC investments by 1060 VC investors in 684 ventures from 1994 until 2011. We model the effect of investor origin and investment mode on the hazards of successful exits and terminations in a competing risks model.

We show that domestic VC investors are more likely to escalate their commitment to a failing course of action and provide novel evidence of contrasting behavior for VCs investing across borders. Whether investing directly or through a local office, cross-border VC investors' lower emotional involvement with the entrepreneur and lower embeddedness in the local economic and social environment, together with an international decision making committee that acts as organizational safeguard, makes them less likely to escalate their commitment.

We contribute first by showing that being a foreigner can induce more rational decision making regarding the abandonment of underperforming projects. Second, we extend existing literature by hypothesizing and demonstrating empirically that geographical heterogeneity has differential impacts on VC proclivity to escalation of commitment, that is, it depends on whether the VC is a domestic, cross-border, or branch investor. Third, we contribute by suggesting that organizational safeguards can be an effective tool to mitigate the proclivity to escalate commitment. Finally, by providing a more fine-grained classification of trade sales and buyouts as successful or unsuccessful exits we offer a methodological contribution to the VC exit literature.

For practitioners, our evidence suggests that domestic VC investors may learn from foreign VC investors to improve decision making processes to reduce the problem of escalation of commitment. The finding that branch VCs do not escalate commitment suggests that their organizational safeguards provided by investment committees consisting of both local and head office executives prevents them from escalating commitment. Domestic VC investors may implement this organizational safeguard by having an investment committee comprising international executives, even for evaluating domestic projects, or by following the decision to terminate by an international VC investor in a syndicated deal. As we have demonstrated that cross-border VC or branch VC may terminate investments more easily when portfolio companies do not meet expectations, our evidence indicates that entrepreneurs should carefully evaluate potential investors and target investors that match their needs.

2. Introduction

Venture capital (VC) investors are professional investors who take equity stakes in young, growth-oriented companies. The VC industry was for long a local industry (Cumming and Dai, 2010; Wright and Robbie, 1998) because geographic proximity to investment targets was deemed essential for efficient deal flow generation and evaluation (Sorenson and Stuart, 2001) and for post-investment monitoring and value adding services (Mäkelä and Maula, 2006). The enhanced domestic competition in maturing VC industries has increasingly driven VC firms to search for investment opportunities abroad (Meuleman and Wright, 2011; Tykvova and Schertler, 2011; Schertler and Tykvova, 2011). As a result, the number of international transactions has now become non-negligible, with one in eight VC-backed companies worldwide now receiving VC from an international investor. A deeper understanding of the international VC phenomenon is hence warranted (Wright et al., 2005).

Research on international VC has largely started from the observation that international VC firms face liabilities of foreignness compared to domestic VC firms, induced by increased geographical, cultural, and institutional distances between VC investors and their portfolio companies (Wright et al., 2005). We highlight how international VC firms have an advantage compared to domestic VC firms. More specifically, we argue and show that international VC firms, whether investing from a cross-border entity or from a local branch office, terminate their failing investments more rationally compared to domestic VC firms, who have a higher tendency to escalate their commitment to a failing course of action.

Terminating investments is particularly important for VC investors as about one third of investments eventually fail (Puri and Zarutskie, 2012). When investments fail to meet initial expectations, decision makers face a “liquidation dilemma”: they may favor continuing to finance the project to retain the option of improvement or they may decide to terminate, which results in the crystallization of certain losses. Persisting to invest in a poorly performing project that eventually fails, however, not only wastes financial and temporal resources but also forgoes alternative and more promising investment opportunities (Li and Chi, 2013). Even for seasoned investors, pulling the plug on underperforming investments is difficult: “[VCs] don't fail because they backed bad companies but because they keep shoveling money into them” (Hardymon et al., 2007:8). VCs therefore put several mechanisms in place to prevent this irrational behavior (Guler, 2007). Nevertheless, VC firms may still be prone to escalate their commitment to a failing course of action (Birmingham et al., 2003; Guler, 2007).

However, previous research has not conceptualized the home country heterogeneity of VC firms and the potential differential implications for escalation of commitment. Our goal is to address this gap by exploring differences in the propensity of international VCs and domestic VCs to escalate commitment when portfolio companies do not meet expectations. We expect that in contrast to domestic VCs, increased cultural and geographical distance faced by international VC firms, leading to lower emotional, social, and institutional pressures, reduces their termination decision biases. While most research on international VC disregards the entry mode, the establishment of a local branch office is a widely used strategy to mitigate the frictions associated with geographic and cultural distance (Dai et al., 2012). This raises the question whether VC firms investing from a branch office resemble more domestic VC firms or VC firms investing from their home country across borders. We therefore further differentiate between international VC firms investing from their home country (cross-border VC firms) and those investing from a local branch office (branch VC firms). This important distinction has been largely ignored in the international VC literature.

We use a unique hand-collected sample of technology based companies from seven European countries that received initial VC investment between 1994 and 2004. The sample contains longitudinal data on 1618 unique rounds of VC investments by 1060 VC

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