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Determinants of venture capital investments in emerging markets

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ABSTRACT

Jeng and Wells (2000) initialized the examination of venture capital (VC) determinants across countries. Meanwhile, we enlarge their scope using aggregated VC funding in 118 countries, 78 being considered emerging markets, using panel data from 2000 to 2013. We show that M&A activity, legal rights and investor protection, innovation, IP protection, corruption and also corporate taxes and unemployment have impact. We reveal the economic magnitude and direction of impact of the determinants to be different for the two country categories for several parameters, enhancing previous research by emphasizing that VC investment drivers can be different for developed and developing countries.

1. Introduction

Venture capital has established its role in the economy several decades ago and does not only levy financial, but also non-financial capital. Gompers and Lerner (1998) describe venture capital as a means of providing capital to firms who may not have the necessary independent financial means, thus requiring external financing. It acts as an intermediary between lenders and borrowers for markets where these two have to incur costs to come together (Jeng and Wells, 2000). Venture capitalists are said to be active investors, pursuing such activities as monitoring and influencing strategic decisions of the firm by such means as controlling

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rights and holding board seats (Gompers and Lerner, 1998). A venture capitalist's ability to add value is further reflected by the duration of the investment (Cumming and Johan, 2006). Although venture capitalism was founded in the United States, many countries have followed suit, turning venture capital into a global phenomenon (see e.g., Gompers and Lerner, 1998; Félix et al., 2007; Cumming et al., 2010a).

The internationalization of venture capital has prompted it to be defined slightly differently in some markets, as Jeng and Wells (2000) indicate in their paper by defining venture capital in US terms, rather than European terms. Even though these country or region related changes exist, it is found that even in countries with bank-centered markets, a differentiation made by Black and Gilson (1998), banks that are legally entitled to hold equity stakes in venture startups, nonetheless refrain from doing so in most cases. As indicated by Jeng and Wells (2000), this is brought on by the problematic of corporate governance. Therefore, even in bank-centered markets, venture capital fills the financing gap that exists for venture startups. Further research in related fields has shown that the structures taken by venture finance also vary and that there is not one optimal structure (such as using convertible preferred equity) (Cumming, 2005). In other words, venture capital is a globalized concept and its structures can vary within as well as between countries.

Venture capital has been a much studied subject which, nevertheless, still requires further investigation. Amongst these empirical expeditions is the question of what factors attract venture capital investments and how a factor may affect the investments of a country in terms of venture capital. The studies which are in existence apply and evaluate a multitude of variables which are said to be responsible for attracting and increasing or also decreasing these investments into a country. However, for the most part, these studies assess country investments in developed economies such as Europe (see e.g., Félix et al., 2007; Cherif and Gazdar, 2011) or when undeveloped nations are included do not focus on these specifically. It is the objective of this paper to draw on a global range of countries whilst evaluating determinants that pose as a particular driving force for venture capital investments into undeveloped countries. In this process, the effects of a range of previously examined variables are considered, such as the effects of different divestments types, corporate taxes, and legal aspects. However, less examined variables are also considered: investor protection as well as bribery and corruption.

Since the beginning of the century, the behavior of venture capital investments has experienced an interesting shift: the amount of venture capital investments into emerging markets has risen. The data shows that in the year 2000, venture capital investments into emerging markets totaled USD 3.25 billion. This represents a ratio of 97.6% of the sum of venture capital investments that were placed in what can be classified as developed markets. This figure decreases to 79.2% by 2013. Accordingly, the share of venture capital investments into emerging markets rose from 2.4% in 2000 to 20.8% in 2013.[1] Total investments into emerging markets in the year 2013 summed to USD 9.8 billion. This development gives credence to the fact that exploring venture capital determinants specifically in the setting of emerging markets is worth pursuing and will likely grow in significance in the years to come.

The fundamental objective of this investigation lies in extending the research performed by Jeng and Wells (2000). It does so in its pursuit of identifying and analyzing venture capital investment determinants, however, in more markets across the globe as well as with an alternative selection of variables. To this end, this paper extends contemporary literature in that it analyzes a global spectrum of nations on various levels of development. These determinants are not broken down to specific continents, regions, or groups of countries, however. Even though the fields herewith investigated still yield much opportunity for succeeding research, our findings provide initial insight into these fields on cross-cultural terrain and enable subsequent research to specify its research questions further. Our findings indicate that for the majority of the variables analyzed, we find concurring evidence of significance in determining venture capital investments in developed markets. The added value that nonetheless exists lies in the global reach of the sample. The primary contribution, however, lies in the findings specific to emerging markets. We show that the direction and magnitude of variables have varying effects: weakening, strengthening, and solely an effect in emerging markets.

Furthermore, literature finds that emerging markets have weaker legal and institutional regimes in place compared to developed economies. For instance, the average score of the Transparency International's corruption index for emerging markets is 3.33 whereas for developed markets it is 7.04 — the difference in means t-test p-value being statistically significant. Such variations ought to have an influence on how policy is created and how practitioners act in the market and could have an influence on the determinants themselves.

[1] Please refer to Fig. 1 for further details.

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