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Syndication and Foreignness: Venture Capital Investments in Emerging and Developed Markets

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ABSTRACT

This paper aims to understand when foreign and domestic firms have different likelihoods of syndication in venture capital investments. Although current theory may imply that foreign firms face the liability of foreignness that constrain their syndication opportunities, empirical studies provide quite mixed evidence. To address this issue, this study emphasizes the contingency roles of settings, experience, and reputation. In particular, I argue that foreign firms are more likely to syndicate, compared with domestic ones, when focal investments are less mature, or when local markets are colder and less capitalized. However, the difference in syndication between foreign and domestic firms decreases when they accumulate more experience or when they acquire higher reputation. I find empirical evidence from a sample of venture capital investments in China, UK, and the Netherlands. Theoretical and practical implications are discussed at the end.

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1. Introduction

International business theorists usually label foreignness with liability (Hymer, 1976; Luo and Mezias, 2002; Miller and Parkhe, 2002; Zaheer, 1995), by proposing that foreign firms face the hazards of unfamiliarity, discrimination, and relation (Eden and Miller, 2004), which ultimately affect their performance negatively (Nachum, 2003, 2010a; Zaheer and Mosakowski, 1997). Recent studies (Gu and Lu, 2014; Nachum, 2010b) have shifted attention from the performance implication of foreignness to the relationship formation of foreign firms in host markets. Empirical results, however, remain quite mixed. Nachum (2010b) finds that foreign firms form fewer interorganizational relationships than domestic firms; Gu and Lu (2014)'s results indicate instead that foreign venture capital (VC) firms have a higher likelihood of syndication; while Li et al. (2008) present that foreign and domestic firms exhibit quite a similar level of relationship utilization. Such conflicting findings request a finer-grained analysis on whether and when foreign and domestic firms have different likelihoods of relationship formation. To address this issue, I emphasize the contingency role of both investment settings (Sorenson and Stuart, 2008) and firm attributes, by examining the syndication of VC firms.

With the internationalization of VC firms (Guler and Guillén, 2010a; Liu and Maula, forthcoming), foreign firms play a non-negligible role in local VC markets (Gu and Lu, 2011). They not only compete with domestic firms for investment and fundraising opportunities, foreign firms also spill their knowledge over to domestic VC firms through investment syndication (Gu and Lu, 2011). Syndication, as a typical type of interorganizational collaboration (Wright and Lockett, 2003; Sorenson and Stuart, 2008), is an important strategic choice for VC firms to diversify risk and create value (Lerner, 1994). Tian (2011)'s study, for example, shows that syndication-backed companies are more likely to have a successful exit of going public and to receive a higher

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IPO (initial public offering) market valuation. Thus, comparing the syndication prospensity of foreign and domestic VC firms is important because it may also help explain their heterogeneous performance in local markets.

In this study, I contend that it is difficult to formulate a simple and assertive proposition on the relationship between foreignness and syndication. Syndication depends on the dual interplay of inducements and opportunities (Ahuja, 2000; Dimov and Milanov, 2010; Gu and Lu, 2014). Although foreign firms may have less opportunities to syndicate as a result of the lack of local embeddedness and trust (Eden and Miller, 2004; Nachum, 2010b; Rangan and Drummond, 2004; Zaheer, 1995), they do have stronger inducements for syndication because they want to access more local information (Nachum, 2003; Petersen and Pedersen, 2002) and reduce investment uncertainty (Liu and Maula, forthcoming). Thus, conceptually, it is hard, or even impossible, to assert whether foreign firms are more (or less) likely to syndicate.

This study forwards our understanding of the roots of foreign firms' syndication by emphasizing investment settings (Sorenson and Stuart, 2008), because the effect of foreignness varies according to location and time (Luo and Mezias, 2002; Nachum, 2010a). In particular, I focus on settings of three aspects: maturity of portfolio companies, market hotness, and market capitalization, because they are closely related to the investment uncertainty that foreign firms experience. Uncertainty is one of the key factors that drive the syndication of VC firms (Dimov and Milanov, 2010; Lerner, 1994; Sorenson and Stuart, 2008). While prior studies usually assume that uncertainty is equally meaningful for all firms, I argue that foreign VC firms are more sensitive to investment uncertainty because domestic firms have local connections, experience, and familiarity (Eden and Miller, 2004), which can mitigate uncertainty. Therefore, I propose that when facing an uncertain investment condition (e.g. earlier stage investments or less promising investment markets), foreign firms would exhibit a stronger propensity towards syndication than domestic firms.

In addition, I examine changes in the choice of syndication as VC firms gain local experience and reputation in host markets. Experience plays an important role in mitigating investment uncertainty (Guillén, 2002; Liu and Maula, forthcoming; Xia et al., 2009). Firms may be different in their perception of and their capabilities to cope with investment uncertainty in host markets, because of the heterogeneous local experience they have accumulated (Guler and Guillén, 2010a). Similarly, research has also documented the essential role of reputation because VC investment markets are quite socially constructed (Lee et al., 2011; Stern et al., 2014). Reputation refers to broad public recognition of the quality of a firm's activities and outputs (Pollock et al., 2015; Rindova et al., 2005). While most studies on VC reputation discuss its performance implications, I emphasize that the increase of reputation may change the way how VC firms perceive opportunities and challenges (Bothner et al., 2012). I therefore examine how reputation and experience affect the syndication of foreign and domestic firms.

This study makes several contributions. First, in order to explain conflicting findings in previous studies, I explicitly analyze the effect of foreignness on relationship formation, by emphasizing investment settings and firm attributes as important boundary conditions. While international scholars usually discuss the effect of uncertainty on foreign firms' decisions (e.g. Liu and Maula, forthcoming), this study stresses that foreign and domestic firms have heterogeneous sensitivities to uncertainty. Second, while studies often investigate experience variance between foreign firms (e.g. Xia et al., 2009), this study emphasizes that the value of investment experience is different for foreign and domestic firms. Finally, whereas existing studies usually focus on the advantage related to reputation (Pollock et al., 2015), this study highlights that the effect of reputation varies from foreign firms to domestic firms. In particular, reputation is more meaningful for foreign firms who lack local legitimacy and familiarity. In the following sections, I review contextual and conceptual background, develop and test hypotheses with a sample of venture capital investments (Lerner, 1994; Kogut et al., 2007) in both emerging and developed markets (i.e. China, UK, and the Netherlands).

2. Contextual and conceptual background

2.1. VC internationalization and foreignness

VC firms are financial intermediaries that operate between ultimate investors and entrepreneurial companies (Guler and Guillén, 2010a; Lerner, 1994), aiming to obtain and share profits through appropriate investments. VC industry emerged in the US around the middle of the 20th century (Gompers and Lerner, 2001; Kogut et al., 2007), and has boosted innovation and economic growth of the US. Such a success of VC industry in the US triggers the development of VC industries in other countries (Guler and Guillén, 2010a) such as China (Ahlstrom and Bruton, 2006; Ahlstrom et al., 2007). Cross-border investments have flourished (Dai et al., 2012; Gu and Lu, 2014; Guler and Guillén, 2010a) as VC firms start to explore more investment and fundraising opportunities abroad. At the same time, foreign VC firms spill over their knowledge to local firms, especially when they participate in local investment syndication (Gu and Lu, 2011).

However, it is usually difficult to invest abroad, due to the liability of foreignness (Bell et al., 2012; Hymer, 1976; Lu and Hwang, 2010; Zaheer, 1995; Zhou and Guillén, 2015). First, foreign VC firms are often less familiar with local institutional environments (Peng, 2003), such as local rules, practices, and behavioral patterns (Eden and Miller, 2004; Zaheer, 1995). Indeed, Bruton and Ahlstrom (2003) and Ahlstrom et al. (2007) show that the VC investment industry in China, or East Asia in general, is largely different from what we have witnessed in the West. Second, foreign VC firms lack social recognition such as reputation, legitimacy, trust, and local embeddedness (Asmussen and Goerzen, 2013; Eden and Miller, 2004; Guler and Guillén, 2010a; Rangan and Drummond, 2004). Extensive studies have shown that VC markets are quite socially constructed (e.g. Lee et al., 2011; Pollock et al., 2015). The extent to which VC firms have opportunities to invest and syndicate is found to be largely contingent on their reputation (Gu and Lu, 2014) and status (Dimov and Milanov, 2010; Guler and Guillén, 2010b; Ozmel et al., 2013; Sorenson and Stuart, 2008). As entrants for host markets, foreign VC firms usually lack both successful performance records for reputation accumulation (Gu and Lu, 2014) and local network embeddedness for status acquisition (Ahlstrom et al., 2007; Lu

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