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The Evolution of Initial Co-investment Syndications in an Emerging Venture Capital Market☆

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ABSTRACT

Prior research highlights the importance of co-investments among foreign and domestic investors in an emerging VC market. Yet, the question of how domestic and foreign VC syndicate partners select each other for their *initial co-investment* remains an open one. The question is important because uncertainty in emerging markets exposes participants to risks associated with higher levels of agency, problems of adverse selection, and potential opportunism. Building on agency theory, we hypothesize and test the risk mitigating effects of economic and social signals on the choice of initial co-investment ties among domestic and foreign VCs in an emerging market. Our work has implications for international management research, the practice of international VC investing, and public policy that tries to stimulate venture driven ecosystems.
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1. Introduction

Venture capital (VC) investing is globalizing at an increasing rate (Guller and Guillén, 2010; Meuleman and Wright, 2011; Aizenman and Kendall, 2012). North American, European, and Asian venture capitalists (VCs) now routinely invest across national borders either directly or in partnership with each other. In fact, over the last two decades, many VCs have leveraged their home country prominence to build cross-regional investment networks (Jääskeläinen and Maula, 2014; Dai et al., 2012). Using these networks, they look to access higher investment returns and broader diversification opportunities in the emerging economies of Asia, Latin America, Africa, and the Middle East. Governments welcome such private capital flows because a robust venture capital market in an emerging economy fosters an entrepreneurial culture and attracts further foreign capital and expertise (Tykvova and Schertler, 2011). Co-investment by domestic and foreign VCs not only helps to establish the domestic venture capital industry but also increases the rate of success among ventures from emerging economies as they seek global markets (Rosiello et al., 2011).

Although prior research does inform what we know about the internationalization of established VCs from developed economies, it falls short in explaining how VC actors step into an emerging venture capital market. *In this paper, we specifically ask: how do domestic and foreign venture capital syndicate partners select each other for their initial co-investment partnership*? The question is significant because internationalization to emerging markets increases risks for VCs venturing abroad and the initial co-investment syndication partnership maybe the most challenging and path dependent step. In emerging venture capital markets,

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standards of practice could be uncertain, legal contracting idiosyncratic, and cultural norms distinctly different from those in the country of origin. Moreover, in their early stages, emerging VC markets also lack the dense investment networks on which VC firms from developed markets typically rely to source opportunities, monitor ventures, and select and monitor co-investors (Hochberg et al., 2007; Jääskeläinen and Maula, 2014). Given that VCs already operate in a risky corner of finance, undertaking investments in an emerging VC market exposes them to additional levels of agency risks—the most immediate of which are problems of adverse selection and opportunism by investment partners. At the same time, internationalization stretches VCs' existing capabilities in selection, monitoring, and value creation. To successfully venture into emerging markets, VCs need to draw on mechanisms that mitigate risks, particularly as they form initial co-investment partnerships.

Building on agency theory, we examine the effects of observable economic and social signals on the choice of syndicate partners among domestic and foreign VCs in an emerging market (Hopp and Lukas, 2014). We test our hypotheses using a decade-long observation window at the dawn of the establishment of the VC industry in Israel (1992–2002). During this period, investors created over 5700 initial dyadic co-investment ties of which 80% involved one or more foreign investors from across the world. Notably, the emergence and sustainability of venture capital markets and, more broadly, the successful growth of venture-driven ecosystems clearly depend on attracting foreign investors and international private capital flows. Because Israel's VC industry is widely considered one of the most successful to ever emerge, we see it as a highly appropriate and vastly under-explored setting for a study that probes the core of how new cross-border syndication partnerships become established in a new venture capital market.

As we move through the paper, first, we describe the Israeli VC context, next provide theoretical development of testable hypotheses, then move to present our methodology and analytic results, and finally discuss their implications and the study's conclusions.

2. Creation of a venture capital financed entrepreneurial ecosystem

For all intents and purposes, the opportunity for foreign investors to participate systematically in the financing of entrepreneurial technology firms in Israel was born as a result of proactive public policy. With itself as a co-investor, the Israeli government established the Yozma Program and helped to create a series of structured VC limited partnership funds. The government invited an initial set of skilled international partners to co-invest in the funds thus launching a formalized and internationally embedded VC industry. The objective of the government's policy was to encourage foreign VC firms not only to enter Israel and contribute to the development of a local VC industry but also to underpin the entry into international markets of Israeli high technology firms. In 1993, immediately after our study's observation period opens, the first ten VC funds established through the Yozma Program came into existence. Prior to that, Israel had fewer than ten professional VC funds with a total of approximately $150 million under management. Between 1993 and 1997, the Israeli government invested close to $250 million in an effort to create a VC industry. By 2002, the point at which we close the observation window on our study, the government had exited its investments in the VC funds it helped create and largely successfully privatized the Yozma fund itself. However, Israel's VC community had grown to include more than 150 funds, which had raised close to $10 billion US dollars for investment in high-technology firms (Khavul, 2001, 2005; Avnimelech and Teubal, 2006).

The vast majority of the capital that flowed into the Israeli VC industry came from limited partners based outside of Israel. Moreover, international VC funds, as well as VC arms of corporations, and banks, were active direct participants in VC-led syndication partnerships. For example, after Canada and the UK, Israel was the third most favored destination for US VC investments (Guler and Guillen, 2004; Guler, 2007) and routinely a target destination for scores of other international technology giants in search of research and development, investment, and acquisition opportunities. Our focus on Israeli VC syndication, in the first decade that constituted its period of early emergence, allows us to examine simultaneously the creation of a domestic VC industry through public policy and its subsequent exploitation through private initiative.

New VC firms often face limited deal flow as well as challenges in finding suitable investment opportunities. In addition, they need to assemble sufficient capital to meet a particular investee firm's capital requirements. Therefore, in the early stages, nascent Israeli VC firms and other institutional investors in Israel faced liabilities of newness that created powerful incentives to syndicate with other investors at home and abroad.

Examining our research question in the context of both an emerging and a rapidly growing market afforded us a chance to build a rich, original longitudinal dataset that yields insights into the pattern of VC co-investment ties that arise and evolve over time. We believe that our results can generalize beyond the present empirical setting as they offer insights about the interplay between foreign and domestic investors for international business researchers, venture capital practitioners, and public policy makers.

3. Theory and hypotheses

3.1. VC syndication partnerships: Experience and status

VC syndications, one method of financing high technology start-ups, are voluntary arrangements that involve more than a simple arms-length transaction. In syndication partnerships, multiple investors ally to contribute not only capital but also tangible and intangible resources that a portfolio company requires as it develops and commercializes its innovations. Such partnership generally exists for a set period of years during which the partners take on a number of tasks with the goal of maximizing their return on the investment (Markowitz, 1952). Striking a deal among a syndicate of investors and a portfolio company involves sharing due diligence, structuring the deal, and establishing incentive and compensation systems and ownership positions. Thereafter, once the investment has been made, one or more members of a syndication partnership typically serve as the lead

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