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Does Syndication With Local Venture Capitalists Moderate the Effects of Geographical and Institutional Distance?

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ABSTRACT

Venture capitalists (VCs) face additional risks and costs when they invest in firms located in geographically remote countries or in countries whose institutions differ substantially from those in their home countries. Our study considers foreign VCs' prospect of overcoming these investment obstacles as a rationale for syndicating with local VCs from the investment countries. Through such syndication, foreign VCs may obtain easier access to investment opportunities, improve the risk allocation and face lower information costs. Using a novel dataset of worldwide deals, we draw a diametrically opposed picture for the two kinds of distance: our results lend support to the conjecture that the obstacles of great institutional distance cannot be overcome with the help of a local VC, whereas those of great geographical distance can.

1. Introduction

Venture capital investment is no longer a local business in which US venture capitalists (VCs) invest in US-based entrepreneurial firms. Nowadays VCs based in the US finance a large number of entrepreneurial firms in Asia (especially China and India), Europe and elsewhere. In the last two decades, venture capital industries have developed in many countries and several VCs from these countries have also gone international. In the period 2000–2008, which our sample covers, we found that every third VC invested abroad and more than one third of worldwide venture capital investments were cross-border deals. In many of these deals VCs invested in geographically remote countries or in countries whose institutions differed substantially from those in the VCs' home countries.

The VCs' business model is based on actively monitoring and supporting typically young, risky and intransparent entrepreneurial firms (e.g. Sahlman, 1990). This requires information collection and frequent (to a large extent personal) interaction, which is likely to be more difficult and costly if the geographical and institutional distance between the VC and entrepreneurial firm (EF) is great (e.g. Wright et al., 2005), making distant investments less likely than proximate ones. Investing on great geographical and institutional distances incurs not only larger information and transaction costs, but VCs also face larger risks due to increased unfamiliarity. VCs

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may have developed certain strategies for overcoming the obstacles and reducing the risks of great geographical and institutional distance between them and the EFs they want to invest in. This paper focuses on one of these potential strategies, namely syndication with local VCs. Analyzing our dataset of worldwide venture capital deals, we find that foreign VCs syndicate with a local VC in 57% of all cross-border deals. Syndication may be chosen as a means of reducing the costs and improving the risk allocation that would burden the foreign VC if it invested alone. This is because through syndication the foreign VC may obtain easier access to investment opportunities and face lower information costs and risks.

To test whether the involvement of local VCs moderates the negative effects of geographical and institutional distance on the likelihood of investment and whether this moderating effect works differently for the geographical and institutional distance, we develop a model on the likelihood that a particular VC invests in an EF located outside its home country. To capture the various facets of institutional distance in this model, we follow institutional theory and distinguish between the regulative, normative and cognitive pillars of the institutional environment (Scott, 1995/2001), but we also us a composite measure that includes all these three pillars. We expect that the likelihood of a foreign VC's investment depends negatively on its geographical and institutional distance from the EF, as the risks and costs increase, and we hypothesize that the negative effect of geographical as well as institutional distance will be less pronounced if the foreign VC syndicates with a local VC than if it invests alone. As we will show further down, the evidence that we draw from our dataset of worldwide venture capital deals supports only the first hypothesis: syndication with a local VC makes it easier for the foreign VCs to invest in geographically distant countries but it does not moderate the negative effect of great institutional distance on the likelihood of investment. Obviously, a great institutional distance between VCs deters their cooperation to a larger extent than a great geographical distances does. While syndication with geographically distant (but institutionally close) local VCs might reduce information costs and risks for the foreign VCs, such reduction tends not to occur when foreign VCs syndicate with institutionally distant local VCs.

To the best of our knowledge, our study is the first to consider the prospect of a foreign VC overcoming the obstacles and reducing the investment risks of great geographical and institutional distance to be a rationale for syndicating with a local VC. VCs have many different reasons for wishing to syndicate their investments, most of which have been investigated in the literature mainly on the national level, while international venture capital syndication has been investigated only by a handful of studies. Among these, we should note the study by Guler and McGahan (2006), who demonstrate that US-based VCs do not syndicate more intense when they invest in non-US-based than in US-based ventures; also, that by Meuleman and Wright (2011), who focus on private equity deals from the UK to Continental Europe, rather than on cross-border venture capital deals.

Our paper adds to the research on the moderating effects of syndication and networks. An interesting study on within-country venture capital investments in the US is that by Sorenson and Stuart (2001), who consider the moderating effect of networks and suggest that the embeddedness of VCs in networks moderates the negative effects of geographical distance on the likelihood of investment within one country. In our study we consider the international dimension. This makes us possible to study simultaneously the moderating effects of syndication on institutional as well as geographical distance. Furthermore, our investigations expand past research on moderating effects in the cross-border context, which are an important topic in the literature on international entrepreneurship and new ventures (e.g. Davis et al., 2000; Ionascu et al., 2004). Much of that research concentrates on EFs that expand into foreign countries and often cooperate with local EFs (e.g. via strategic alliances or joint ventures) that help them enter new markets and thus may moderate the negative effects of geographical and institutional distance between the foreign EFs and their (new) target markets. In contrast to these studies, the moderating effects we investigate here involve a third party, namely the local VC, which we postulate to influence how geographical and institutional distances affect the likelihood of the foreign VC's investment.

This research also contributes to the emerging literature on public and corporate governance effects (Cumming and Chakrabarti, 2014) and the strand that focuses on young entrepreneurial companies going international (Zahra, 2014). Our sample companies are affected by the interplay of public and corporate governance systems. While public governance is incorporated in the countries' institutional environments, which we capture with our measures of institutional distance, corporate governance – within a given institutional environment – is pertinent to the rules within firms. Active investors, such as VCs, are supposed to make the corporate governance systems within the companies they finance more effective (Cumming and Johan, 2013). In this context, our study investigates whether the unfamiliarity of the foreign VC with the public governance system in the EF country may be alleviated by the presence of a local VCs that might contribute to improving the corporate governance mechanisms.

Finally, our study is related to the fast growing literature on international venture capital activity.[2] While most studies on international venture capital activity at the micro-level focus only on VCs or private equity investors from a single country (e.g. Guler and Guillén, 2010a, 2010b; Iriyama and Madhavan, 2009; Meuleman and Wright, 2011), we investigate worldwide venture capital deals by using a comprehensive deal dataset covering VCs from 48 countries. A few works in that stream of literature consider the effects of distance and show that geographical distance and certain types of institutional distance negatively affect the intensity of worldwide bilateral venture capital flows between countries (e.g. Aizenman and Kendall, 2012). The literature on international venture capital activity also points out that VCs have difficulties to implement the corporate governance mechanisms they use in

[2] Several studies investigate determinants behind international venture capital flows at the country level (e.g., Aizenman and Kendall, 2012; Schertler and Tykvová, 2011; Schertler and Tykvová, 2012). Other studies focus on one specific factor and its role in the internationalization process—such as networks among VCs in the US (Guler and Guillén, 2010b) and in developed countries (Tykvová and Schertler, 2011), VC's international experience (Guler and Guillén, 2010a) or the role of immigrants in US cross-border investments (Iriyama and Madhavan, 2009). A few studies deal with performance of international venture capital deals and the role played by the investor origin and syndication. Bertoni and Groh (2014) suggest that foreign investors generate additional exit opportunities for their portfolio companies. Nahata et al. (2014) and Cumming et al. (2006) relate EF country legal institutions to success. Yet other studies focus on the EF perspective; e.g. Mäkelä and Maula (2008) investigate how an EF succeeds in attracting a foreign VC.