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Venture capitalists' value-enhancing activities under weak protection of law[☆]

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ABSTRACT

Using two sets of hand-collected survey data, we studied the value-adding activities of venture capitalists (VCs) operating in the weak legal environment of China. VCs exert value-enhancing efforts in addition to monitoring through trust considerations. We identified the effects of three types of trusts, strategic reputation-based (C-trust), knowledge-based (K-trust), and identification-based (I-trust), on a company's performance while investing venture capital in China. We find that the C-trust acts only through increased use of complementary resources to improve a firm's performance. K-trust and I-trust can also stimulate in two other ways by reducing transaction costs and improving team-spirit.

1. Introduction

The Chinese venture capital industry has been growing strongly over the past several years, as has the general economy. In 2010 among 359 disclosed PE/VC funds, 235 completed their fundraising with USD 30.418 billion, and 124 started their fundraising with USD 40.756 billion (ChinaVenture, 2011).[1] To put this into perspective, in 2010 the commitment of funds to 119 VC funds in the US was USD 11.6 billion, a drop of 14% compared with the already dismay year of 2009. Among 336 private equity funds USD 86.3 billion were raised in 2010, down 16% from 2009 (Dow Jones Private Equity Analyst Press Release, Jan. 12, 2011). Megginson (2002) argues that though the U.S. is often considered as the “model” VC system, it is inevitable that the VC industry will continue to internationalize. While the Chinese success may seem impressive, we argue in this paper that researching the venture capital industry tells us not only about the prosperity it generates but answers some important economic questions too. Specifically, we study the value-adding effects of non-contractual mechanisms, such as strategic consideration, trust and team work between the entrepreneurs (Es) and the venture capitalists (VCs).

During the venture capital investing process, the role of a VC is mainly characterized as a monitor to resolve the agency problem

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[1] The breakup of the funds is as follows. There were 804 disclosed VC deals involving USD 5.668 billion. This was an increase of 65.1% in the number of deals and 93.3% in the total amount compared with 2009. There are 375 PE investment deals with USD 19.613 billion. This was an increase of 114.0% in the number of deals and a 16.1% increase in the total amount compared with 2009.

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between VCs and Es (Jensen and Meckling, 1976). Previous research has found that VCs provide other valuable services to the portfolio companies (Admati and Peiderer, 1994, 1995; Lerner, 1994; MacMillan and Kulow Roubina, 1989; Sapienza, 1992).[2] These services, based on cases in developed countries and regions such as the US and Europe, rely on the assumption that the rule of law will prevail: The contracts will be enforced by the court and the ownership rights will be observed. Thus it makes sense for VCs to contribute and add value to the portfolio companies. In China, as in many other developing countries, this assumption is unlikely to hold. There are ample anecdotes about the hardships foreign VCs meet in China. We provide two such examples in the appendix A. A general summary about the development of the law pertaining to the Chinese economy can be found in Clarke et al. (2008). The challenging question is to what extent the VCs will still contribute to the success of new ventures,[3] apart from monitoring the entrepreneurs' behavior. The answer to this question is especially important now, because during the life time of a new venture, the fund raising process and the exit process seem to be very prosperous and more regulated over recent years in China.[4] Yet so far there has been no systematic study on the exact nature of value-adding activities during the period between fund-raising and the exit date.

Researchers have already started to look into the problem. Allen et al. (2005) in their seminal survey of the Chinese financial system pointed out that the major stimulus of the impressive Chinese growth over the past three decades came from the private sector. Financing these private firms is much harder than for state-owned enterprises. One significant channel is through VC or private equity (PE). It is expected that contractual arrangements play much smaller roles. The authors argue that the most important factor that shapes China's social values and institutions is the set of beliefs related to Confucius that are different from western beliefs on the rule of law. The system of alternative mechanisms plays an important role in driving the economic growth in the private sector and they are good substitutes for standard corporate governance mechanisms. Allen, Qian and Qian (2008) hypothesized that the relationship between VC and E might be a big factor. Yet researchers have not had much understanding about this relationship because a lack of the data. In this paper, by using a unique set of survey data, we show that indeed trust between VCs and Es contributes to the performance of new ventures. Specifically, we argue theoretically and show empirically that there are three different types of trust or mechanisms that enhance a firm's value: strategic reputation-based (C-trust), knowledge-based (K-trust), and identification-based (I-trust).

More importantly, we go beyond the simple link between trust relationship and a firm's performance and study how the two are linked. Motivated by prior research and confirmed through interviews, we identify three mechanisms that trusts can engage to improve a firm's performance: better use of complementary resources, reduction of costs associated with asymmetric information, and team spirit. We provide empirical evidence that different trusts work through different channels.

In terms of research design, we use a two-stage data collection process: First, we used a case study approach through detailed interviews to establish the hypothesis and then we designed a questionnaire for collecting a large sample. In terms of methodology, in addition to the traditional regression analysis, we used a Structural Equation Modeling (SEM) approach to confirm our findings. SEM has been used extensively in psychology, education, medicine, management and economics etc. It is a simple extension of structural equation estimation, which incorporates measurement errors, latent variables, and correlation among variables.

Of course, our work is not the first to consider the effect of trust in the venture capital industry. The study by Bottazzi, Da Rin and Hellmann (2012) is the closest to ours. They found that trust significantly affects investment decisions. However, there are two important differences between our work and theirs. The definition of trust in their paper is the trust among people from different nations, while the trust in our paper is between the VCs and Es in a new venture firm. Secondly, they mainly studied the effects of trust on investments decisions, while we study how inter-personal trust affects the behavior of a firm. Other related work on the effect of trust includes the effect of trust on stock markets (Guiso, Sapienza, and Zingales, 2008).

To the best of our knowledge, our paper is the first to study systematically how trust adds value to the venture capital industry in China. The results obtained here illustrate the importance of building trust between the VC and E to improve the performance of a new venture. Our paper also contributes to the blooming growth of literature on the studies the effect of trust in emerging countries, which have weak legal systems.

2. Theoretical background, hypothesis and first stage interview results

2.1. Theoretical background

The research on industrial organizations has various definitions of trust. Here we use the general definition from Rousseau et al. (1998): Trust is a psychological state comprising the intention to accept vulnerability based upon positive expectations of the intentions or behavior of another. This definition incorporates the expectation of any future beneficial action, whether it is based on self-interest or on a relationship (Saparito et al., 2004). As such, it has been used extensively in the relevant research (For example, Zacharakis and Shepherd, 2001; Saparito and Chen, 2001).

Cumming and Johan (2007) show that the quality of a country's legal system matters for the propensity of conflicts between entrepreneurs and VCs. However, it is also important that many non-legal and non-contractual features are vitally important to both

[2] More recent work includes Hellmann and Puri (2000, 2002), Hochberg et al. (2007), Hsu (2006), Kaplan and Stromberg (2004).

[3] We use portfolio companies and new venture firms interchangeably in this paper.

[4] Besides the fundraising activities by both foreign and domestic investors, there was a rapid growth in IPO activities in China. In 2010, 490 Chinese firms started to list on the local and foreign stock exchanges. This is 155.7% increase compared with 2009 and raised a total of USD 106.875 billion. There were 220 VC/PE-backed IPOs, accounting for 44.8% of all deals with 269 foreign institutional investors (ChinaVenture, 2011). The introduction of the ChiNext exchange in 2010 will contribute more robust growth in IPO soon.