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National distances, international experience, and venture capital investment performance☆

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ABSTRACT

This study examines how the performance of cross-border venture capital investments is affected by national institutional and cultural distances between the environments of venture capitalists (VCs) and investee ventures. We propose that institutional and cultural distances will decrease VCs' effectiveness in conducting venture capital activities and negatively affect investment performance in terms of exit success, and obtain supportive evidence while controlling for geographic distance. We further analyze how VCs can use their international experience to mitigate the negative consequences of national distances. We find that while broad international experience in diverse countries attenuates the deleterious effects of institutional distance in a significant way, it does not have a similar impact in attenuating the negative effects of cultural distance.

1. Executive summary

This study examines how the performance of international venture capital investments is affected by the distances in national institutional and cultural environments between venture capitalists (VCs) and investee ventures. The increased internationalization of the venture capital sector has triggered the interest of entrepreneurship scholars in studying how distinct national institutions and cultures impact key entrepreneurial activities and venture capital financing. We extend existing literature by addressing the impact of two distinct but complementary national distances on exit success of cross-border venture capital investments: institutional and cultural distances. While the cultural distance perspective captures the impact of national differences in cognitive patterns and values, the institutional distance perspective captures the impact of differences in regulatory systems as well as in institutionalized practices, beliefs and assumptions that govern and order business relationships. Cultural distance raises barriers to information sharing, reduces trust, and increases transaction costs. Institutional distance increases the risk of legitimacy loss, sanctions, and additional transaction costs associated with incongruence of institutionalized practices. We thus hypothesize that both cultural and institutional distances will have a negative impact on the likelihood of a successful exit in the form of venture IPO or sale.

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The high costs of institutional and cultural distances have raised the issue of whether VCs can mitigate national distances by gaining cross-border investment experience. We address two types of investment experience. While broad international experience reflects the breadth and scope of experience in terms of the diversity of countries in which a VC has invested, host country-specific experience represents the depth or intensity of investment in the host country. We posit that both types of cross-border experience can reduce the adverse effects of institutional and cultural distances on exit success. While broad international experience in diverse countries increases awareness of national differences and allows VCs to develop adaptive capabilities to translate experiences gained from one environment to another, host country experience allows for deeper acquisition of institutional and cultural knowledge and the opportunity to perfect VCs' routines in a particular host country.

We further expect that the ease with which VCs can develop their international capabilities to mitigate negative consequences of institutional and cultural distances varies. Institutions tend to be more explicit and reflected more strongly in practices that are salient and susceptible to change. In contrast, values, beliefs, and cognitive patterns that are carried through culture tend to be more tacit and more impervious to change. Further, compared with behaviors incompatible with local cultures, behaviors incompatible with local institutions are more likely to be formally punished or endure social sanctions, which propel VCs to learn from experience. We thus propose that international experiences have more salient mitigating effects on the adverse impact of institutional distance than on the impact of cultural distance. To our best knowledge, the current study represents one of the first attempts to examine the different roles of experience in mitigating costs arising from both institutional and cultural distances.

We test our arguments by using a large sample of cross-border venture capital investments between 1996 and 2008 and controlling for geographic distance. Both logit and Heckman analyses show that institutional and cultural distances negatively affect the likelihood of exit success. Further, broad international experience alleviates the negative effect of institutional distance but neither VCs' broad international experience nor VCs' host country-specific experience mitigates significantly the negative impact of cultural distance.

Concerning the insignificant mitigating effects of international experience with regard to *cultural* distance, we suggest that the episodic nature of VCs' engagement in the host countries may not provide sufficient exposure to support deep learning that is required to bridge the cultural gap. Moreover, in many cases the perception of dissimilarity and thus the liability of outsidership cannot be completely eliminated because of attributes that are difficult to change (e.g., differences in physical features).

Our study has several implications for practice. First, distances matter to performance, but the main challenges VCs face may not arise from physical or geographic distance, as often discussed in the current literature, but from institutional and cultural distances. Second, our analysis suggests that VCs need to be aware of the differences in acquiring institutional and cultural knowledge. When recruiting professional staff members, VCs might want to prioritize the possession of diverse international experience by candidates, and ensure that candidates can adapt to changes in local environments so that the knowledge they possess remains current.

2. Introduction

Venture capitalists (VCs) play a critical role in providing not only scarce financial resources but also value-added services to high-potential entrepreneurial ventures (Baum and Silverman, 2004; Busenitz et al., 2004; Dimov and Shepherd, 2005; Hellmann and Puri, 2002; Sapienza, 1992). From its origins in the U.S., the venture capital industry has expanded around the world. Recent years have witnessed an increase in the number of venture capital deals across national borders (Aizenman and Kendall, 2008; Kenney et al., 2008; Li, 2012; Wright et al., 2005). Through international investments, VCs are able to tap into growth opportunities in foreign markets (Dai et al., 2012; Guler and Guillen, 2010). They may, however, face significant liability of foreignness in international investment because of the challenges arising from geographic, cultural, and institutional distances between home and host countries (Zaheer, 1995).

The current study examines how the performance of international venture capital investments is affected by the distances in national institutional and cultural environments between VCs and investee ventures. The idea that national distances affect the conduct and performance of businesses operating across borders has been at the core of international business research for decades (see, for example, the seminal works of Hymer, 1960; Johanson and Vahlne, 1977). Recently, the increased internationalization of the venture capital sector has triggered the interest of entrepreneurship scholars in studying how distinct national institutions and cultures impact key entrepreneurial activities and venture capital financing (e.g., Bruton et al., 2009; Bruton et al., 2005). For instance, Dai et al. (2012) have investigated the effect of cultural distance on VCs' cross-border investment behavior and performance in Asia. The current study extends existing literature in three important ways.

First, we analyze the effect of institutional distance on VCs' cross-border performance in addition to the effect of cultural distance, the focus of prior studies (Dai et al., 2012). While the cultural distance perspective captures the impact of national differences in cognitive patterns and values (Hofstede, 1980; Kogut and Singh, 1988; Shenkar, 2001), the institutional distance perspective captures the impact of differences in regulatory systems as well as in institutionalized practices, beliefs and assumptions that govern and order business relationships (Peng and Heath, 1996). Our study thus provides economic and sociological insights to complement the social–psychological insights derived from the cultural distance perspective. Furthermore, we argue that institutional distance influences the effectiveness of VCs' primary activities and the performance of cross-border investments through mechanisms that are distinct from those that are triggered by cultural distance. Specifically, while cultural distance leads to rising barriers to information sharing, reduced trust, and increased transaction costs, institutional distance increases the risk of legitimacy loss, sanctions, and additional transaction costs associated with incongruence of institutionalized practices. Incorporating the two distinct but complementary perspectives of national distance in the theoretical