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Cross-border venture capital flows and local ties: Evidence from developed countries

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ABSTRACT

Using a unique global dataset from developed countries, this paper provides evidence that not only traditional determinants of international capital flows affect cross-border venture capital flows, but that ties among local venture capital investors are related to *size* and *style* of these flows. Our results on size indicate that both number and value of cross-border flows between two countries increase with tie intensities within the local venture capital industries in both countries. Our results on style suggest that strong local ties go hand in hand with more intensive ties to foreign investors. Thus, rather than protecting the local market and fending off competition from foreign investors, local tie intensity seems to stimulate international syndication and expansion of venture capital financing across borders, which allows venture capital investors to build geographically diversified portfolios and to add value by building cross-border syndicates. These effects seem to be stronger for those foreign investors who already have experience in the particular destination country.
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1. Introduction

Why and how do local ties matter for cross-border venture capital flows, which have experienced rapid growth worldwide in recent years? In the context of the US venture capital industry, Hochberg, Ljungqvist and Lu (2010) argue that investors form strategic regional networks to fend off competition from other US regions. If this argument also holds for cross-border venture capital deals, we should observe that countries with strong local ties attract less cross-border flows than countries with weak local ties because strong ties would discourage foreign investors from entry. We call this our market protection hypothesis.

However, this story may be too simplistic, since cooperation between a foreign and a local investor may be advantageous to both of them. Due to the reciprocal nature of relationships in the venture capital industry, cross-border syndication may help increase the deal flow when local venture capital investors become foreigners in the home countries of the investors they partner with. Moreover, cross-border syndication may contribute to portfolio diversification. Therefore, one may expect that strong ties among local investors will only discourage foreign investors' stand-alone deals but not necessarily those cross-border deals that are syndicated with local investors. We call this our collusion hypothesis.

In addition, cross-border syndication might add value to portfolio companies when foreign and local investors bundle their complementary skills. While the local investor, who is located near the company, has superior knowledge on the local market, practices, rules, technology, and patterns of behavior, the foreign investor is able to help implement the company's internationalization in foreign product and capital markets. Investors with dissimilar backgrounds and experience may profit by learning from each other. Intensive local ties may facilitate cooperation with foreign investors because local venture capital investors have experience in structuring syndicated deals and may be able to exploit the value-adding advantages and information benefits allowed for by cross-border syndication. Foreign investors may prefer to cooperate with local actors with strong ties because such embeddedness may serve as an indicator for the trustworthiness of the local investor. Our third (value-adding) hypothesis suggests that strong ties among local investors will encourage domestically syndicated cross-border deals but they will not affect stand-alone deals.

We use a novel dataset of cross-border venture capital flows between developed countries and carry out our empirical analysis of the role of local ties in cross-border venture capital flows in three steps. In the first step, we investigate how ties in the local venture capital industry affect the *size* of cross-border venture capital

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flows between all country pairs in our sample. Our results indicate that strong local ties stimulate cross-border venture capital flows. In other words, foreign investors come from countries with strong local ties and prefer to place their money in countries with strong local ties. These results are robust towards controlling for the endogeneity of the local tie measure. This evidence contradicts our market protection hypothesis.

In the second step, we investigate how local ties affect the *style* of cross-border flows. Here, we distinguish between deals with participation of a local syndication partner and deals in which only a foreign investor is involved. We find that the investment style of foreign investors depends on the strength of local ties in the country in which the portfolio company is located. When local ties are strong, foreign investors more often syndicate deals with local investors. While deals syndicated among local and foreign investors are positively related to local ties in the destination country, stand-alone deals do not seem to be affected by the local tie intensity. We interpret these results as evidence in line with our value-adding hypothesis and contradictory to our collusion hypothesis. This effect is less pronounced for those foreign investors who invest in the particular country for the first time. This result indicates that for these investors it is more costly to join local networks than for investors who have already invested in this country in the past and potentially already have contacts to local investors.

We complement these investigations on size and style of cross-border venture capital flows with a performance analysis in the third step. Our results suggest that syndicated cross-border deals, but not stand-alone deals, go hand in hand with higher success rates. This result is consistent with the view that cross-border syndication is beneficial because investors may combine complementary skills and foreign investors may profit from lower monitoring costs as well as lower information costs.

The contribution of our research to the existing literature is threefold. First, our analysis adds to the emerging literature on internationalization in venture capital industries. Lerner and Schoar (2005) find evidence that venture capital investors use different kinds of securities when investing in destination countries with a different legal system than their home (i.e., venture capital source) country. Bottazzi, Da Rin, and Hellmann (2009) demonstrate that the source country's legal system is more important than that of the destination country in determining contract structures and venture capitalists' behavior. Balcarcel, Hertzel, and Lindsey (2010) suggest that poor legal enforcement in a destination country leads to sub-optimal contracts which negatively affect cross-border venture capital inflows. Kaplan, Martel, and Stromberg (2007) find that, when investing abroad, venture capitalists' experience shapes contract characteristics. Finally, Bottazzi, Da Rin, and Hellmann (2010) demonstrate that trust among nations affects cross-border venture capital flows.

Cumming and Johan (2007a,b) look at institutional investors' allocation of funds among local and foreign venture capital investors. Guler and Guillén (2010a,b) investigate whether home-country network advantages of venture capital investors headquartered in the United States affect their expansion into other countries. Finally, Aizenman and Kendall (2008) or Schertler and Tykvová (in press) look at traditional determinants of global cross-border venture capital flows. Our paper offers insights not only into the role of the traditional determinants of cross-border flows, but also into the role of the local venture capital industries' structure in attracting cross-border flows.

Second, our paper is related to the literature dedicated to the syndication of venture capital deals. Venture capital investors typically form syndication networks (e.g., Hochberg, Ljungqvist, & Lu, 2007; Lerner, 1994; Sorenson & Stuart, 2001) to achieve portfolio diversification and larger deal flows. Moreover, through the syndicate partners' complementary skills and contact networks (Lindsey, 2008; Hsu, 2004), they are also able to generate additional value in their portfolio companies (Brander, Amit, & Antweiler, 2002). Our paper is one of the first papers that offer a joint empirical investigation of the internationalization and cross-border syndication within worldwide venture capital industries.

Third, our research adds to the broad literature on international capital flows. While little is known about cross-border venture capital flows, a considerable amount of research has been carried out in the field of international capital flows. For example, Froot, O'Connell, and Seasholes (2001), Brennan and Aranda (1999) and Brennan and Cao (1997) argue that international portfolio flows are strongly influenced by stock market returns in the destination countries. These studies also place particular emphasis on transaction costs which arise when carrying out international investments (Barron & Valev, 2000; Portes & Rey, 2005; Portes, Rey, & Oh, 2001). Our results suggest that transaction costs captured by traditional measures, such as cultural and geographical distance, also play an important role in cross-border venture capital flows.

The remainder of this paper is organized as follows. In Section 2, we discuss how cross-border venture capital flows may be related to the structure of local venture capital industries. Section 3 is devoted to the description of our dataset. In Section 4, we analyze the relationship between the size of cross-border flows and local ties. Section 5 analyzes the style of cross-border deals by distinguishing between cross-border deals with and without a local syndication partner. In Section 6 we link the style of venture capital investors' cross-border activity to the success rate of their deals. In Section 7 we summarize our results and conclude.

2. Cross-border flows and ties among local venture capital investors

Theoretical literature has put forward several motives for syndication, such as risk diversification (Chowdhry & Nanda, 1996; Wilson, 1968) and information sharing (Casamatta & Haritchabalet, 2007; Millon & Thakor, 1985; Sah & Stiglitz, 1986). Recent empirical literature investigates these and other motives for national syndication. For example, Brander et al. (2002) and Cumming and Walz (2010) find evidence that syndicated venture capital (in the former study) and private equity investments (in the latter study) generate larger returns, suggesting that syndicates are able to add more value to portfolio companies than stand-alone investors.

Information sharing may motivate local venture capital investors to syndicate deals with other local investors and thus build up regionally concentrated networks. However, networking among local investors operating in a particular market may have yet another motivation, as pointed out by Hochberg et al. (2010). Local investors may build strategic alliances with other local investors to protect their local markets and fend off competition from non-local investors. In this case, it may be difficult for foreign investors to gain access to deals in countries with strong local ties. Based on this argumentation, we formulate our market protection hypothesis.

Hypothesis 1 *(market protection)*. Strong ties among local investors will discourage cross-border inflows.

Venture capital investors from countries with strong local ties may, however, invite foreign venture capital investors to jointly participate with them in local deals. Due to the reciprocal nature of relationships in the venture capital industry (e.g., Chowdhry & Nanda, 1996; Pichler & Wilhelm, 2001; Tykvová, 2007) local investors may in this way gain access to foreign deals so that cross-border syndication may help increase the deal flow and contribute

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