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The influence of experiential, inherited and external knowledge on the internationalization of venture capital firms

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ABSTRACT

This paper examines the effect of different types of international knowledge accumulation on the internationalization of venture capital firms, as a particular type of professional service firms. We distinguish between experiential knowledge acquired through previous activities, inherited knowledge through the management team and external knowledge through network partners. Hypotheses are developed for both the likelihood and the number of cross-border investments. The hand collected dataset comprises a combination of survey and archival data on a unique sample of 110 venture capital firms from five different European countries. Analyses indicate a positive effect of experiential and inherited knowledge on internationalization, but external knowledge has limited impact. Intense international contacts even decrease international activities. Together, these results highlight the importance of experiential and inherited knowledge to overcome information asymmetries inherent in the internationalization of professional service firms, and of venture capital firms in particular.

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1. Introduction

Increasing globalization is one of the most important developments in the professional service industry. Over the last 30 years, professional service firms have benefited from the possibilities of foreign activities for growth and diversification (Contractor, Kundu, & Hsu, 2003; Hitt, Uhlenbruck, & Shimizu, 2006). International activities are however associated with a steep increase of information asymmetries (Filatotchev & Wright, 2011). These are particularly pronounced in professional services, due to the knowledge-intensity of these activities and the inherent difficulties for customers to verify the quality of the services ex-ante and to monitor them ex-post (Sanchez-Peinado & Pla-Barber, 2006; von Nordenflycht, 2010). Despite these adverse circumstances, our knowledge of how professional service firms deal with information asymmetries in cross-border activities is still limited. Venture capital (VC) firms' cross-border investment activities are an interesting example of professional service firms' recent global development. VC firms' value creating activities reside to a large extent in their ability to address information asymmetries and agency issues. The latter are heavily influenced by local market conditions and practices (Filatotchev & Wright, 2011).

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A central theme in international business research is the importance of foreign knowledge accumulation that helps firms to deal with internationalization uncertainties (Yli-Renko, Autio, & Tontti, 2002). The goal of this paper is to understand how foreign knowledge accumulation influences cross-border activities under conditions of large information asymmetries that characterize the internationalization of professional service firms and VC firms in particular. Early internationalization theorists recognized the importance of internal knowledge development (Johanson & Vahlne, 1977). Subsequent findings from new venture internationalization studies (e.g. Oviatt & McDougall, 1994) showed that relevant foreign market knowledge may originate from outside the focal firm as well (e.g. Autio, 2005; Johanson & Vahlne, 2009). We therefore focus on both internal and external sources of foreign knowledge accumulation in this study: firm-level experiential knowledge acquired through previous foreign investments, inherited knowledge through the prior foreign work experience of its management and external knowledge through its foreign network partners.

A unique hand-collected international dataset combining survey and archival data from 110 VC firms in five European countries is used as empirical setting. A broad definition of VC is used, including not only seed and start-up capital but also later stage deals such as buy-outs (Wright & Robbie, 1998). Our results stress the positive effect of foreign knowledge accumulation on the international investment behavior of VC firms. Experiential knowledge has a large effect on international investment activity both in terms of the likelihood and the extent of international investments. Inherited knowledge through previous international activities of its managers is important as well, particularly for the likelihood of being international. Our results on external knowledge accumulation point to the importance of the foreign network structure and particularly to the differences between the number of international partners (network range) and the intensity of the cooperation with these partners. While the range of the international network does not have a significant effect on the likelihood of being international, the intensity of cooperation negatively affects it. International VC firms with intense foreign network relationships are more likely to become domestic. Finally, external knowledge accumulation does not affect the extent of international activities.

Our study makes several contributions. This paper advances our understanding of international professional services. As internationalization is associated with a steep increase of information asymmetries and agency problems, it is interesting to study the effects of foreign knowledge accumulation in a setting where these issues are particularly pronounced (Schertler & Tykvová, 2011). In addition, our results increase our knowledge on the international development of VC firms. While previous research has mainly focused on the effects of information asymmetries on the behavior and outcome of VC firms outside their home country (e.g. Chemmanur, Hull, & Krishnan, 2010; Devigne, Vanacker, Manigart, & Paeleman, 2011), this paper focuses on the effects of information asymmetries and agency risks on the internationalization pattern of VC firms.

The paper is organized as follows. We first develop our theoretical framework including hypotheses, followed by a description of the research method and the presentation of our results. Thereafter, findings are discussed and the paper concludes with implications.

2. Theory development and hypotheses

Cross-border activities increase information asymmetries and agency risks (Filatotchev & Wright, 2011), making a firm's knowledge base especially important for overcoming these risks. Knowledge on foreign market activities may be accumulated through three different sources: (i) firm level experiential knowledge, developed through previous international activities, (ii) inherited knowledge, acquired by individual managers through their previous managerial experience in an international context and (iii) external international knowledge accessed through a firm's network of foreign co-investment partners.

Information asymmetries and agency risks are especially important for venture capital firms, as they typically specialize in managing these risks through careful screening and due diligence before investing and through actively monitoring the venture after the investment (Manigart et al., 2006). VC firms pursue different strategies to mitigate higher levels of information asymmetries and agency risks in cross-border investments. For example, they may invest in more information-transparent firms (Dai, Hoje, & Kasscieh, 2011), use more staged financing (Chemmanur et al., 2010) or seek cooperation with a domestic co-investment partner (Devigne et al., 2011; Meuleman & Wright, 2011). We expand below how the three different sources of knowledge may also help to overcome problems of information asymmetries and agency risks in cross-border VC investment activities.

2.1. *Experiential knowledge*

Experiential knowledge is acquired and developed within an organization through its previous experience. International experience has traditionally been proposed as one of the primary sources of knowledge accumulation for international development (Johanson & Vahlne, 1977): internationalization is regarded as a learning process where firms create procedural knowledge about how to handle higher agency risks and monitoring costs that accompany the higher uncertainties of international activities (Chetty, Eriksson, & Lindbergh, 2006). Experiential knowledge can be beneficial in a VC context to assess opportunities and to mitigate information asymmetries. This gradually results in a smoother incorporation of general internationalization knowledge within the firm, positively affecting the perception about its ability to further engage in cross-border activities (Cohen & Levinthal, 1990). As a result of this learning process, firms that develop

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