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Do networks of financial intermediaries help reduce local bias? Evidence from cross-border venture capital exits

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ABSTRACT

Contributing to the literature on local bias and financial networks, we examine how direct and indirect network ties of financial intermediaries mitigate the effects of distance and preference for local investments. In our analysis of cross-border venture capital exits, we find that proximity within networks facilitates cross-border transactions, which suggests that network distance is an important dimension of distance in addition to its geographical and cultural dimensions. The results also suggest that network distance affects the reach and quality of mediated information: indirect ties to partners' partners, with their broad reach, facilitate the identification of investment opportunities, whereas direct ties, which have certification effects, facilitate quality assessment.

1. Executive summary

This paper examines how networks of financial intermediaries affect the distribution of information among the network members across distances.

In our analysis of cross-border venture capital exits, we study the effects of direct (first-order) and indirect (second-order) ties and of the different types of information that they distribute on the impact of investors' local and cultural biases. We examine the exit market selections of venture capital-backed companies from EU-15 countries and find that the more a venture has non-domestic ties, both direct and indirect, the more likely is an exit to a non-domestic market. Furthermore, we examine target market selections in non-domestic exits and find that the network ties of the ventures increase the likelihood of an exit to markets to which the venture has preexisting investor network ties.

When comparing the effects of direct and indirect network ties, we find that they differ in their potential to help mitigate two key problems related to imperfect information, the identification of investment opportunities and the evaluation of their quality. Our results suggest that indirect ties provide reach, reducing the problem of opportunity identification, which is important for trade sale exits to happen. On the other hand, direct ties appear to serve as a channel for the transfer of rich information, reducing the problems of investor quality assessment, and consequently facilitate IPO exits to markets to which the venture is connected.

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These findings contribute to the literature on proximity preference (Coval and Moskowitz, 1999) or local bias of investors by demonstrating the significance of inter-organizational ties in mitigating the effects of distance and preference for local investments. Our results suggest that the preference for proximity is intrinsically tied to the distribution and receipt of information. Investors that are able to connect to non-local markets despite the distance have a smaller social distance from these markets and are consequently able to obtain better information from them. In addition to mitigating local bias based on geographical distance, network ties also mitigate bias based on cultural distance (Guiso et al., 2009).

As one of the first studies focusing on cross-border venture capital exits, this paper also makes several contributions to practice and policy concerning international entrepreneurship and venture capital. For entrepreneurs, our results show that early-stage financing choices may have long-standing consequences for the development of their ventures. Having both foreign investors and domestic investors with strong international syndication networks may facilitate an international exit. For venture capitalists, our findings offer additional justification for internationalization strategies and cross-border syndication (Dai et al., 2012; Meuleman and Wright, 2011). Although cross-border syndicates are more challenging to build and manage than domestic ones, they may be valuable because they increase the ability of the investor to make successful international exits. For institutional investors, the findings of this paper suggest that the international syndication of venture capital firms may be another valuable factor to consider in fund investments. Finally, for policy-makers, the findings suggest that encouraging cross-border venture capital activity may help improve value creation from investments made in science, technology, and innovation.

2. Introduction

The observation that not all investors are equal in acquiring the information that they require to make informed investment decisions has long been present in the financial literature. The basic problems related to the identification of investment opportunities (Merton, 1987; Stigler, 1961) and the evaluation of their quality (Akerlof, 1970; Megginson and Weiss, 1991) affect investors differently, resulting in demonstrated effects such as bias towards local investments and market segmentation. Although the variation in information endowments has mostly been examined in relation to investor-specific factors such as geographical location, resources, and search costs, the recently recognized role of networks in the financial markets suggests that investors are also affected by their relative positioning in interorganizational or interpersonal networks.

Focusing on cross-border venture capital exits as our focal phenomenon, we examine the effect of network distance on information distribution in financial markets by combining the well-documented bias of investors towards local investment targets (Coval and Moskowitz, 1999)[3] with insights from the emergent literature on financial networks (Hochberg et al., 2007; Kogut et al., 2007). More specifically, we examine whether network distance affects the distribution and acquisition of information in financial markets in the way that geographical (Degryse and Ongena, 2005; Lerner, 1995) and cultural distance (Chan et al., 2005; Grinblatt and Keloharju, 2001; Guiso et al., 2009; Hau, 2001; Sarkissian and Schill, 2004) do. To test this proposition, we examine how network distance in terms of the direct and indirect network ties of financial intermediaries mitigates identification and evaluation problems in international venture capital markets, in which the effects of imperfect information may be expected to be particularly pronounced.

By analyzing the effects of network distance on the likelihood of cross-border exits and exits to particular foreign markets using a sample of 4216 European venture capital-backed companies, we observe that network proximity between the investor and the target company facilitates information acquisition through networks of financial intermediaries and attracts investments from otherwise geographically and culturally distant investors. We measure a venture's network distance to non-domestic markets and focus on first-order, direct ties and second-order, indirect ties in the VC investor network that connect the venture to non-domestic markets. We also observe that the likelihood of non-domestic IPOs is associated only with direct network ties, which suggests that the quality of the information mediated through ties deteriorates with increasing network distance. Our results indicate that network ties provide a mechanism for information distribution and that network distance affects information distribution: indirect, second-order ties to partners' partners have a broad reach, thus alleviating the identification problem, whereas direct, first-order ties also provide the certification effects that alleviate the quality evaluation problem.

The main implication of these results is that information distributed by network ties mitigates the effects of the preference for proximity: the likelihood of investment increases with respect to network proximity. By explicitly addressing network distance, the results contribute to the current research, which has mainly examined networks using proxies such as geographical distance (e.g. Hau, 2001), group membership (e.g. Duflo and Saez, 2002; Hong et al., 2004), and shared location (e.g. Hong et al., 2005; Kelly and Ó Grada, 2000) and which thus has not provided information regarding the actual structure of the ties. Furthermore, the few studies that explicitly address the actual ties between investors have not considered how network ties interact with and

[3] This preference is illustrated, for example, by investors' tendency to overemphasize domestic stocks in their portfolios (Ahearne et al., 2004; Cooper and Kaplanis, 1994; French and Poterba, 1991; Tesar and Werner, 1995), to invest in geographically close markets (Portes and Rey, 2005) and to use local exchanges for trading (Tse, 1999). Earlier research has identified two main sources of this bias. First, the 'home bias' literature focuses on investment barriers between national markets, such as governance practices and investor protection (Dahlquist et al., 2003; Doidge et al., 2004), political risks (Stulz, 2005), restrictions on capital controls (Chan et al., 2005), and taxes (Chan et al., 2005). However, many studies find that barriers to investment only partially explain the bias (e.g. Cooper and Kaplanis, 1994). Consequently, the second stream, the 'local bias' literature, has focused on information concerns among local and non-local investors (Coval and Moskowitz, 1999, 2001; Grinblatt and Keloharju, 2001; Ivkovic and Weisbenner, 2005). Short distances (Degryse and Ongena, 2005; Lerner, 1995) and shared language and culture between investors and investment targets (Chan et al., 2005; Grinblatt and Keloharju, 2001; Hau, 2001; Sarkissian and Schill, 2004) have been found to facilitate greater familiarity with investment targets (Coval and Moskowitz, 1999; Dvorak, 2005; Huberman, 2001). For reviews of the topic, see Lewis (1999) and Karolyi and Stulz (2003).