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Venturing into the unknown with strangers: Substitutes of relational embeddedness in cross-border partner selection in venture capital syndicates

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ABSTRACT

Syndicating with prior partners through relationally embedded ties may be widespread, but not always optimal when investing across borders especially if few prior partners operate in the focal market. However, the substitutes of relational embeddedness for trust creation in cross-border partner selection are poorly understood. We develop and test a model of how relational embeddedness interacts with structural embeddedness and legal and normative institutions and how relational embeddedness and these three substitutes jointly affect cross-border partner selection in venture capital syndicates. We test the hypotheses in the context of cross-border venture capital syndication in 12 European countries. Our findings based on a case-control analysis suggest that although relational embeddedness is a key driver of future partnering, structural embeddedness and trust generating institutions such as high quality legal frameworks and industry associations facilitate cross-border partnering and diminish the need to rely on relationally embedded ties in cross-border partner selection.
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Executive summary

In cross-border venture capital (VC), syndication plays an important role in investment performance. Yet, a major research gap concerns understanding of the selection of new foreign VC partners in an existing syndicate. This choice is a critical decision as it determines the skills, knowledge, and resources a portfolio firm will gain access to. Further, firms entering syndicates face considerable uncertainty given the unpredictability of the behavior of partners and the associated costs of opportunistic behavior.

Risks and uncertainties in interfirm collaborations may be mitigated by favoring familiar and existing partners. As such, relational embeddedness, that is, prior direct ties, is a major driver of partner selection in interfirm relationships. However, relying on familiar partners may pose problems for internationalizing firms as oftentimes there is a limited choice of relationally embedded partners in new foreign markets or prior partners might even not be available. With few relationally embedded ties, firms entering foreign markets may have to choose partners that they know less about and have no prior collaboration with. A key question,

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therefore, is what mechanisms can act as substitutes for relational embeddedness for trust creation in cross-border partner selection when previous ties are scarce or missing?

We examine the extent to which macro-level institutions and structural embeddedness interact with and influence the role of relationally embedded ties in cross-border partner selection. We examine how the legal environment of the target company interacts with relational embeddedness facilitating cross-border partnership formation, as well as the role of VC industry associations in connecting VC firms across borders and how these can act as substitutes for direct prior ties.

We test our hypotheses using data on the formation of cross-border VC syndication ties in a final sample comprising 1355 cross-border VC investments rounds involving 873 different target companies in 12 European countries during 2000 to 2008. In total, 705 different foreign investors coming from 35 countries joined as a new syndicate member. We employ a case-control selection procedure as a research design to study the likelihood that a particular foreign VC joins an existing syndicate in a new investment round.

We find, as hypothesized, positive main effects of both direct and indirect ties between the existing syndicate and the prospective partner on tie formation. We also find a negative interaction effect between the direct and indirect ties suggesting a substitution effect of indirect ties on the effect of direct ties. We find support for our interaction hypothesis of the quality of regulatory institutions of the host country of the underlying target to decrease the reliance on prior partners. We did not find support for the interaction effect of shared industry association membership to decrease the reliance on prior partners, but there was strong support for the hypothesized positive main effect of shared industry association membership on tie formation.

Our findings make the following contributions. First, we extend the relational embeddedness approach to partner selection literature by hypothesizing and showing that in a cross-border context indirect ties can substitute for missing or limited direct ties. Second, we highlight the role of legal institutions and cross-national industry associations in facilitating cross-border partnership formation. Previous studies have not examined cross-level interactions between social networks and macro-level institutions in facilitating or constraining these decisions. Third, we show how relational embeddedness and institutions interact in partnering choices, and in particular how the efficiency of contracting through strong legal institutions in the host country facilitates partnering with new partners. Fourth, we show how normative institutions with respect to standardized working practices spread by cross-national VC industry associations facilitate cross-border partnering choices. Finally, we demonstrate how the institutional context influences the nature of reliance on existing ties.

1. Introduction

Venture capital (VC) investing has become increasingly international (Aizenman and Kendall, 2012; Cumming et al., 2010; Guler and Guillén, 2010b; Liu and Maula, 2016; Wright et al., 2005b). In cross-border VC, syndication plays an important role in investment performance (Chemmanur et al., 2016; Cumming et al., 2016; Dai et al., 2012; Devigne et al., 2013; Nahata et al., 2014). Yet, there remain major gaps in research on *how* VC firms co-invest across borders. One of the neglected issues concerns the evolution of cross-border VC syndicates, specifically involving the selection of new foreign VC partners in an existing syndicate. A cross-border VC syndicate involves two or more VC firms from different countries taking an equity stake in an investment for a joint payoff to be realized when exiting the investment after a relatively long investment period. The choice of VC partners determines the skills, knowledge, and resources a portfolio firm will gain access to (Brander et al., 2002). Further, firms entering syndicates face considerable uncertainty given the unpredictability of the behavior of partners and the associated costs of opportunistic behavior (Dimov and Milanov, 2010). The selection of appropriate VC partners, therefore, is a critical decision (Dimov and Milanov, 2010; Meuleman et al., 2010; Sorenson and Stuart, 2001) that is poorly understood, especially in the cross-border VC setting.

In general, risks and uncertainties in interfirm collaborations may be mitigated by favoring relationally embedded, that is, familiar and existing partners (Gulati and Gargiulo, 1999). Built by repeated interactions, relational embeddedness facilitates trust formation and information transfer, and increases joint problem solving between partners (Uzzi, 1997). Accordingly, relational embeddedness, that is, prior direct ties, is a major driver of partner selection in interfirm relationships (Gulati and Gargiulo, 1999; Sorenson and Stuart, 2001; Sorenson and Stuart, 2008; Zhelyazkov and Gulati, 2016).

Despite this focus on relational embeddedness in the literature on (domestic) interorganizational relationships, relying on familiar partners may pose problems for internationalizing firms as oftentimes there is a limited choice of relationally embedded partners in new foreign markets or prior partners might even not be available. Excessive reliance on relationally embedded prior partners often leads to suboptimal outcomes even in domestic settings (Uzzi, 1997), a problem likely to be even greater when entering new markets and operating in a new environment that would require new knowledge with fewer prior partners to choose from. Recent growth in VC internationalization suggests many VC firms entering foreign markets face a liability of foreignness as they have limited experience of working with local partners. With few relationally embedded ties, firms may have to choose partners that they know less about and have no prior collaboration with.[1]

A key neglected question in the literature, therefore, is what mechanisms facilitate the formation of cross-border partnerships when previous ties are scarce or even missing? In other words, what mechanisms can act as substitutes for relational embeddedness for trust creation in cross-border partner selection? In answering this question, we combine two streams of theory that provide insights into mechanisms that help create trust and facilitate information transfer: social network theory and

[1] In our sample, 715 of the realized ties were formed with VCs without prior ties with any of the existing syndicate members.

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