As venture capitalists cross borders, they look for institutional trust

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Venture capitalists (VCs) are increasingly investing across jurisdictions, with the vast majority of these cross-border investments being carried out in a syndicate of two or more VCs. This paradigm shift is of interest to governments seeking to further develop local immature venture capital markets by attracting both foreign funds and expertise. Researchers, such as my co-authors **Daniel Hain, Daojuan Wang and I**, also have an interest in deciphering this changing paradigm and understanding the determinants of cross-border venture capital investments.

Local bias has long been considered inherent in financial intermediary activity, especially so for venture capital. Investment in innovative activities involves considerable uncertainty and is characterized by at least two factors. At the outset, there is asymmetric information: one party usually has access to better information than the other; and during the investment process there may be agency problems, when one party is supposed to act on behalf of another but conflicts of interest get in the way. Therefore, frequent and open interaction between investor and investee within close proximity appears necessary for these investments to succeed. A new, growing body of literature, however, suggests a paradigm shift towards a more globally distributed venture capital investment pattern.

In our research we examine worldwide venture capital investment flows from 2000-2012 and consider the effects of geographical, cultural, and institutional proximity as well as institutional and interpersonal (relational) trust. Geographical proximity and local expertise or knowledge is used by VCs to identify innovative ventures and to gather the information required to mitigate their significant financial risk. The physical distance between the VC and the innovative start-up firm may determine the frequency and openness of their interactions.

Prior research finds that differences in legal systems increase information asymmetries, the cost (legal and contractual) and the risk of investment. More dissimilar and inefficient legal systems impede the ability of a VC to finance firms and, thus, hamper the rate of investment. In addition to legal differences, we also consider cultural distance as it is associated with diverging values, business ethics, and codes of conduct. Countries with higher cultural distance show higher mistrust, and discourage risk sharing among potential investors. That tends to represent a major obstacle for cross-border investments.

Institutional trust is present prior to the interaction among parties and refers to the trust in the institutional environment, which includes factors related to the legal framework and its enforceability as well as soft factors, such as a society's attitude towards behaving fairly and honestly.

In contrast, relational trust unfolds gradually through repeated interactions between parties over time. Both institutional and relational trust are very important in cross-border venture capital deals, but they differ in their influence, depending on the participant composition (foreign only vs. foreign and domestic VCs) of the investments and the institutional setup of the destination country (developed vs. emerging economy).

We believe that while institutional trust is not attached to a particular relationship, it serves to ease the way in establishing one, as it mitigates the effects of lack of proximity in cross-border investments. It is pretty much a belief in the system over anything else. As the relationship is established and relational trust is built, the perceived uncertainty of the investments gradually declines while a mutual understanding develops, and both parties move towards a more symmetric information base. Thus, even in the absence of relational trust, we expect countries with high institutional trust to hold higher venture capital inflows and syndication activities, despite potential social and geographical distance.

In brief, we find that the higher the geographical and cultural distance, the lower the likelihood of cross-border investment. However, venture capital flow does appear to move from high-growth countries to low-growth countries; therefore, it appears that VCs are willing to take on the higher risk of investment in emerging economies. Our findings suggest that high-market capitalisation and low corruption levels in the destination country encourage VCs to overcome local bias and consider an investment there.

Our findings also suggest that VCs mitigate the investment risk with social exchange among a syndicate comprising at least one local VC to overcome lack of proximity. What is interesting is that while relational trust helps overcome high geographical, cultural, and institutional distance, institutional trust has a more positive impact on cross-border venture capital flows from developed to emerging economies. This may be because VCs may prefer to rely on their familiarity with established institutional factors in making investment decisions and do not necessarily view relational trust as a substitute for institutional trust.

Sophisticated foreign VCs, for example, may believe they are sufficiently capable of assessing the viability of an innovative firm, and are not reliant on the information gathered after having social exchanges with less sophisticated local VCs, though such information may still mitigate investment risk. Another explanation for institutional trust having more of an impact on cross-border venture capital flow from developed to emerging markets is that VCs from the developed economies would prefer not to dilute their reputational capital by investing with less reputable VCs from emerging economies.

Governments hoping to attract both foreign venture capital investment and arguable more sophisticated value added expertise from foreign VCs should be building institutional trust as it provides the foundation for building up a critical mass of initial trust to enter a relationship involving proximity.

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Notes:

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