Cross-border venture capitalists are less patient with under-performers

blogs.lse.ac.uk/businessreview/2016/06/28/cross-border-venture-capitalists-are-less-patient-with-under-performers/

6/28/2016

Oxstem, an Oxford biotech spin-off focusing on regenerative medicine for age-related diseases, recently raised a record £16.9 million at start-up (Ward, 2016). The money was invested by the local Oxford Sciences Innovation fund and two American venture capital (VC) investors. Why is this important?

Seed and early-stage venture capital were mainly provided by local investors in the past, as entrepreneurial companies need the hands-on advice of their investors to grow and develop. Investors also need to understand and monitor what their portfolio companies are doing. Investing across borders thus puts investors at a disadvantage compared to local investors: it brings liabilities of foreignness.

Nevertheless, the VC industry is becoming increasingly international and foreigners invest abroad at an earlier stage. Syndicating with a local investor is one strategy to overcome the liabilities of foreignness: the local investor can interact frequently with the entrepreneurs, help them and monitor what they're doing. For a start-up, it is beneficial to get money from a combination of local and international investors, as both bring complementary skills, experiences and networks to the table. There is strong empirical evidence that entrepreneurial companies funded by a combination of local and international investors tend to outperform those that have only local investors.

Venture capital investors are frequently confronted with under-performing ventures, however. We know from earlier research that U.S. VC investors tend to escalate their commitment to under-performing ventures and continue to invest, even when new information shows the portfolio company does not meet expectations (Guler, 2007). This non-rational human decision-making has been widely documented in other situations. What is novel about our research is that we differentiate between domestic investors, cross-border investors and foreign investors investing through a local branch office.

We studied 684 young European high-tech companies that received VC and followed them until the VC investors exited or up to ten years after the first investment (whichever came first). In total, 1060 different VC firms had invested in these companies, in more than 1600 rounds. Combined, this allowed us to analyse 3222 investment decisions, of which 2399 by domestic investors, 568 by cross-border investors and 255 by branch investors. Almost half of the cross-border VC investors' investments originate outside the EU.

Our results suggest that, on average, VC investors in European ventures tend to escalate their commitment to a failing course of action. Additionally, we show that domestic VC firms have a significantly higher probability to escalate commitment when a portfolio company fails to meet its expectations compared to cross-border VC firms.

We argue that these findings are driven by the larger geographical and cultural distance between entrepreneurs and cross-border investors. This makes cross-border investors less emotionally attached to the entrepreneur and less socially embedded in the portfolio company's community compared to domestic investors. They thereby face lower emotional, social and normative pressures from entrepreneurs and stakeholders, such as the government or other local businesses, making it easier for them to stop investing – which often leads to bankruptcy or liquidation.

Branch investors share characteristics of both local and international investors. International venture capitalists investing from a local branch typically employ local investment managers. The proximity of the branch office to the entrepreneurial company, and the strong embeddedness of local investment managers in the entrepreneur's community, should make them behave like local investors. We nevertheless find that branch investors behave more like cross-border investors in terminating underperforming ventures: their probability to escalate commitment is lower than that of domestic VC firms. We explain this by branch investment committees including both local and head office executives preventing escalation of commitment. Head office executives are less embedded in the local community and have lower emotional ties to the entrepreneurs, hence effectively shielding them from institutional pressures to continue to invest.

Our research has implications for VC investors. We show that being a foreign VC investor has positive effects as it eases terminating underperforming investments. The finding that branch investors are less prone to escalate commitment compared to domestic investors – despite employing local investment managers and the geographical proximity to the portfolio companies – suggests that their organizational safeguard provided by investment committees consisting of both local and head office executives prevents them from escalating commitment to a failing course of action. Domestic VC investors may hence mimic this organizational safeguard by including distant executives in their investment committees. Further, if foreign syndicate members abandon a project, domestic investors should carefully consider whether and why they should invest further in the same project.

Our study also has important implications for high-tech entrepreneurs. Given the difficulty in raising finance from outside investors, high-tech entrepreneurs are often under pressure to accept finance whenever and wherever they can find it. Yet, as we show, not all investors have the same commitment to portfolio companies that do not meet expectations. While attracting foreign investors may be beneficial for portfolio companies when they perform well (Devigne et al., 2013), they terminate investments more easily when portfolio companies do not meet expectations. Entrepreneurs searching for finance should therefore carefully evaluate and target investors that match their needs.

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Notes:

- *This article is based on Escalation of commitment in venture capital decision making: Differentiating between domestic and international investors, in Journal of Business Venturing, Volume 31, Issue 3, May 2016, Pages 253–271*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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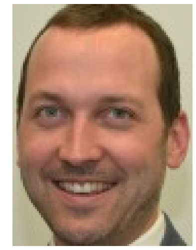
David Devigne currently works as a Life Science investment manager at ParticipatieMaatschappij Vlaanderen (an investment company managing a portfolio of €1,1 billion in assets) and is active as a research fellow at Vlerick Business School and Ghent University. He obtained a master degree in Pharmaceutical Sciences (2005), a master degree in Economics and Business Administration (2006), and a PhD degree in Applied Economics (2013) from Ghent University. He worked as a researcher at the Department of Corporate Finance at Ghent University in 2007, and at Vlerick Business School from 2008 to early 2014. His doctoral research focused on private equity and entrepreneurial ventures in Europe, which is the topic he continues to investigate in his current research.



Sophie Manigart is full professor of corporate finance and Gimv Private Equity Chair at Vlerick Business School and Ghent University. She is associate editor of *Entrepreneurship Theory and Practice*. She has published numerous articles in leading international academic journals. Her research focuses on entrepreneurial finance, both from the demand and the supply perspective, and on the real effects of entrepreneurial finance choices on a venture's development. She is a recipient of the Academy of Management Entrepreneurship Division Mentor Award. She is a member of the board of Gimv, AXA Belgium, the Belgian Venture Capital and Private Equity Association, among others.

Mike Wright is Professor of Entrepreneurship at Imperial College Business School, Director of the Centre for Management Buyout Research, and a visiting professor at Ghent University. He is co-editor of *Strategic Entrepreneurship Journal* and of *Academy of Management Perspectives.* He has published over 50 books and more than 400 articles in leading international journals. His research focuses on entrepreneurial ownership mobility and entrepreneurial finance. He is Chair of the Society for the Advancement of Management Studies. He is a Past Chair of the Academy of Management Entrepreneurship Division and a recipient of that Division's Mentor Award. He has been ranked #1 worldwide for publications in academic entrepreneurship and in entrepreneurship. He is a member of the BVCA Research Advisory Committee. His research is regular covered in the financial and other media.