DISTRESSED PORTFOLIO COMPANY EXIT AND CROSS-BORDER VENTURE CAPITAL INVESTORS: AN ESCALATION-OF-COMMITMENT PERSPECTIVE (SUMMARY)

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SUMMARY

DISTRESSED PORTFOLIO COMPANY EXIT AND CROSS-BORDER VENTURE CAPITAL INVESTORS: AN ESCALATION-OF-COMMITMENT PERSPECTIVE

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Principal Topic

Ventre capital (VC) investors face a liquidation dilemma when portfolio companies (PCs) underperform: they may either further finance the PC to keep the option of improvement or terminate it, which entails certain losses (Tversky & Kahneman, 1992). Prior research has shown that VCs escalate their commitment to a failing course of action (Guler, 2007). We argue that escalation of commitment is more prevalent when domestic VCs (DVCs) invest, compared to cross-border VCs (CBVCs). The smaller geographical and cultural distances DVCs face, result in lower transaction costs and higher emotional attachment (Mäkelä & Maula, 2005; Guiso et al., 2006, 2007, 2008; Bottazzi et al., 2008). Moreover, lower costs and difficulties to acquire and process reliable soft information on PCs and local market conditions increase the DVCs’ probability to escalate commitment as they will focus more on soft information, use less high-powered contracts and apply lower hurdle rates compared to CBVCs (Bengtsson & Ravid, 2009; Chen et al., 2010). The goal of this study is to empirically investigate the probability of escalation of commitment by DVCs as compared to CBVCs.

Method

We use longitudinal data on 759 PCs in 7 European countries that received initial VC between 1994 and 2004. We track the identity and characteristics of their VCs over investment rounds and collect detailed information on the PCs including exit type and timing. Escalation of commitment is analysed focusing on the hazard rate of successful or unsuccessful exits following an investment round (Guler, 2007). Competing risks are analysed with proportional hazards models (Fine & Gray, 1999).

Results and Implications

We show that both DVCs and CBVCs are less likely to terminate investments as they participate in more investment rounds. The probability of having a successful exit of DVCs declines significantly more over rounds compared to CBVCs, however. This suggests that DVCs are more prone to escalate commitment. Proximity is hence an important factor driving escalation of commitment. As such, this study contributes to extant research by differentiating between DVCs and CBVCs.

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