2 Examination of Foreign Venture Capitalists' Role in Developing Economies

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Abstract

In the United States, *venture capitalists* (VCs) played an important role in supporting innovative companies and establishing emerging industries. Consequently, much of the literature on VCs is characterized by a Western bias. However, faced with crowding markets in the home territory, Western VCs have joined the internationalization wave and became increasingly interested in transitional economies. This paper examines the specificities and consequent challenges of developing economies for incoming *foreign venture capitalists* (FVCs) through discussion of (1) number, type and stage of opportunities for investments, (2) possibilities of exiting options from the investment, and (3) the state of the legal framework pertaining to intellectual property rights, overall transparency, and government policies in place. Upon examining the challenges, this paper concludes with the resulting differences in the role FVCs play in developing economies by suggesting that the role of FVC will first serve as a (1) selecting mechanism identifying high potential companies, (2) knowledge transfer mechanism, especially in management related issues, (3) networking mechanism, helping both host countries' companies to internationalize and developed firms to tap into developing markets. Only once all the institutional frameworks become conducive to facilitating venture capitalist's operations as seen in the U.S. for example, can we expect the practice of venture investing to encourage the "proper" type of entrepreneurship, and initiate the "start up" culture we typically envision when talking about the role of VC investment in the Western context.

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1 Introduction

"Until a few years ago, venture capital was as American as an apple pie" (Patricof, 1989, p. 227). Consequently, the knowledge we gained so far on the behavior and issues underlining venture capital firms' operations has been accumulated and built on samples of Western firms, with a predominantly U.S. – bias (Bruton and Ahlstrom, 2003; Mitra, 2000; Wright, Lockett and Pruthi, 2002). Indeed, VC has played a critical role in supporting innovative companies (Kortum and Lerner, 2000) and establishing emerging industries in the U.S. which was a consequence of the combined and interacting enabling factors: presence of high-potential entrepreneurs demanding venture capital finance, stimulating governmental policy, dynamic capital market allowing the investor to easily dispose of his participation (Ooghe, Bekaert and van den Bossche, 1989) as well as overall fiscal transparency for investors and absence of administrative barriers for the entrepreneurs (Balboa and Marti, 2004). Impressive effects of the VC contribution to the American economy have recently been reported by the National Capital Association (NVCA): companies that received venture financing in the period between 1970 and 2003 accounted for 10.1 million jobs and US$1.8 trillion in revenue in 2003, accounting for approximately 9.4 percent of total U.S. jobs and revenues (NVCA, 2004).

Although usually associated with Silicon Valley opportunity-hunters (Forbes, 2004), operating in very near-by communities, venture capitalists have started crossing borders and joined the internationalization wave (Aylward, 1998). Faced with crowding markets in the home territory, VCs are increasingly looking for opportunities outside their national domains. On their radar, along with developed economies of Western Europe and Japan, developing economies are becoming an increasingly interesting target (Bruton and Ahlstrom, 2003; Dauterive and Fok, 2004).

Today, developing economies in general, and increasingly their VC industry development in particular, take center stage in much of today's popular business press (e.g. Romaine, 2001; Schwartz, 1994; Simons, 2004). Academic community also called upon research testing or comparing western models' applicability in the context of these transitioning countries (Hoskisson, Eden, Ming Lau and Wright,

2000). Yet despite the growing popularity of China, India, and other Asian countries as well as CEE economies, there is only a handful of academic articles reporting on activity of VCs in developing countries (Wang and Ang, 2004). Few possible reasons for this come to mind: (1) in most of the developing economies VC activity barely started developing in the 1980s, with 1990s making a take-off point for most of them, meaning that we are just starting to observe some of the results of investments made by VC funds (Balboa and Marti, 2004; EVCA Special report, 2004); (2) researchers are having difficulty on gathering reliable data on transition economies as well as disentangling different methodologies and definitions of VC across countries (IVCA, 2003; Kenney, Han and Tanaka, 2002[1]) used to collect the data which complicates gaining deeper insights; (3) finally, it is also a fact that confidential nature of private equity (including VC) portfolios makes it hard to get precise data on sources and types of investments as well as expected and achieved return rates from particular transactions. As a result, most of the understanding on VCs we have today comes from single country studies, mostly represented by China (e.g. Bruton and Ahlstrom, 2003; Dauterive and Fok, 2004; White, Gao and Zhang, 2002; Zhou, 2002) and India (e.g. Mitra, 2000; Wright et al., 2002) in Asia, or Hungary (Karsai, Wright and Filatotchev, 1997) in CE Europe.

Given the young age of the extant literature on VC in developing economies, most studies are of exploratory and descriptive nature (Wang and Ang, 2004), paying attention to tracking changes in policies that governments have set to facilitate development of VC, examination of the resulting structure of players in the VC industry, and discussion of patterns of investment pertaining to specific countries. In this paper, we aim to focus on one specific but increasingly important player in the industry – foreign venture capitalist (FVC). More specifically, the aim is to examine the challenges of the specific nature of developing economy's environment FVCs face, and how those influence the resulting role they play in developing economies.

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[1] *The National Venture Capital Association (U.S. NVCA), European Venture Capital Association (EVCA) and Asian Venture Capital Journal (AVCJ) define their categories of venture capital differently, making it difficult to compare these relatively broad categories across regions. For example, NVCA is very careful to exclude private equity from VC; AVCJ is not quite as rigorous in its definitions, while EVCA simply includes private equity investors in its reported statistics.*

Specific historical developments and institutional conditions distinguish developing economies from those of the West, as government and societal influences make a stronger impact on every aspect of business operations (Hoskisson et al., 2000). In the context of venture capitalists' operations in general, the focus is on the following: (1) number, type and stage of opportunities for investments, (2) possibility of exiting options from the investment, and (3) interacting with both opportunity attractiveness and exit options, the state of the legal framework pertaining to intellectual property rights, overall transparency, and government policies in place. It has already been shown that all different institutional mechanisms operating in developing economies force FVCs to adapt their strategies (Wright et al., 2002) and exhibit distinct behavior in monitoring investees (Pruthi et al., 2003). How the mentioned contextual variables influence the role FVCs play in a developing economy, will be discussed in the following sections.

2 Venture capital and venture capitalists

Prior to engaging in a discussion of the role of foreign venture capitalists in emerging economies, it is important to shed some light on the definition of venture capital. American literature understands it to be an investment by specialized venture capital organizations (VC funds) in high-growth, high-risk, often high-technology firms that need capital to finance growth (Black and Gilson, 1998). However, outside the U.S. domain, this definition often excludes for example, buy-out financing that enables mature firm's managers, or shareholders to acquire the firm from its current owners, where in Europe (both Western and CEE) this is very often the case in point (Balboa and Marti, 2004).

Strictly speaking, *venture capital* is only a subset of private equity investment, and as such is recorded in the U.S. literature. However, not all venture capitalists invest in "start-ups." While venture firms will invest in companies that are in their initial start-up modes, venture capitalists will also invest in companies at various stages of the business life cycle. A venture capitalist may invest before there is a real product or company organized (so called "seed investing"), or may provide capital to start

up a company in its first or second stages of development known as "early stage investing." Also, the venture capitalist may provide needed financing to help a company grow beyond a critical mass to become more successful ("expansion stage financing").

Their investment in a company may be extended throughout the company's life cycle and therefore some funds focus on later stage investing by providing financing to help the company grow until reaching a point where it is able to attract public financing through a stock offering or trade sale. At the other end of the spectrum, some venture funds specialize in the acquisition, turnaround or recapitalization of public and private companies that represent favorable investment opportunities (NVCA, 2004).

Therefore it is important to acknowledge that (1) outside the United Sates, venture capital is often used as a synonym for private equity (IVCA, 2004), and (2) venture capitalists can invest in all above outlined stages, not only seed and startup, as predominantly perceived in the U.S.

3 Foreign Venture Capitalist's opportunities in developing economies

For venture capital to evolve in an economy, the concept of entrepreneur must become a part of the societal framework (Bygrave, 1989). Venture capitalists are opportunity seekers (Bygrave, 2001). Abundance and visibility of entrepreneurial activity are necessary to attract their attention (Guler and Guillen, 2004). This is particularly the case for foreign venture capital firms engaging in cross border activities, whose primary motivation and objectives are achieving high ROI figures (White, Gao, and Zhang, 2002). Therefore, it is necessary to examine the number of opportunities offered to FVCs, but even more importantly, the nature or type of the opportunities at hand.

The most comprehensive indicator of cross-country entrepreneurial activity (including many developing countries) is the Global Entrepreneurship Monitor

(GEM), which publishes a TEA (total entrepreneurship activity) index[2] for over 40 countries world-wide. It is interesting to notice the variation of the index across developing countries captured by GEM. Sharp contrasts are seen as entrepreneurial activity was uniformly low for Eastern European countries, and at the other end of the spectrum, developing Asian countries marked the highest end of the TEA index[3] scale (even higher than U.S. and EU) (GEM, 2002). Findings evidence the development of entrepreneurial spirit[4] in developing economies, which: (1) creates opportunities for foreign investment (Dauterive and Fok, 2004) giving rise to development of increased interest of FVCs (Guler and Guillen, 2004); and (2) implies differences in the pace of VC development across regions.[5]

However, going beyond the overall number of opportunities evidenced by TEA, and looking at the motivation for entrepreneurial activity shows a less promising picture in terms of innovativeness usually connected to entrepreneurship. Breaking up the TEA index shows that developing economies have a much higher proportion of necessity based, rather than *opportunity* motivated entrepreneurship, which among other things influences the direction and nature of the business: opportunity entrepreneurs are the ones that by far constitute the source of innovative, high impact ventures, (GEM, 2002) i.e. those that would be typically considered natural targets for FVCs, used to abundance of such ventures in their developed home markets. This urges us to shift the discussion from the often cited "large number of opportunities opening in developing economies" and refine it with the nature of these opportunities, to see where FVCs find their playing field in developing economies.

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[2] The TEA index is a measure that identifies individuals that are active in either the start-up phase or managing a new business.

[3] Eastern European countries represented in the TEA index are: Croatia, Hungary, Poland, Russia, Slovenia; and the group of developing Asian countries is formed of China, India, Korea and Thailand (GEM, 2002).

[4] In contrast to GEM (2002), conclusions based on a recent survey on entrepreneurial spirit in CEEs and EU by Schöfer and Leitinger (2003) show starkly different conclusions: "Although the CEE countries were under communist governments for more than 40 years, the entrepreneurial spirit (of CEEs) is very close to EU average. The fact underlines the positive attitude of the CEE countries towards the transformation of their economic systems". We must caution however, that while this study examined the attitude towards entrepreneurship, GEM reports the actual activity, which is more pertinent to our discussion on FVCs.

[5] Venture capital finance has a longer history in Asia, and in 1998, the stock of venture capital outstanding in developing countries in Asia has been more than double than that in Central and Eastern Europe (Aylward, 1998).

Above GEM findings reflect both historical development of developing economies, as well as the institutional frameworks still in place, despite many changes that are being introduced both in legal and economic respect. Historically, the legacy of central planning systems restricted the incentives for organizational actors to introduce, adopt or diffuse innovations proactively (White, Gao, and Zhang, 2002). Governments were responsible for targeting and allocating resources for innovation, and were doing so inefficiently. There were no efficiency-based criteria for performance of organizational actors. Profits, or market competition as such were not parts of the system, jointly presenting detriments to development of innovative entrepreneurial initiatives. This left companies transitioning from a planned centralized system to a free market one in need for acquiring and developing managerial capabilities, competent people understanding the new environment (Child and Pleister, 2003), and overall restructuring of extant practices, operations, and principles of corporate governance (Dockery and Herbert, 2000). If they were to survive the market selection, and continue growing, changes were necessary. This presented FVCs with a different set of opportunities; rather than keeping the focus on rare and too risky seed–stage investments, interest shifted into expansion, mezzanine, buyout and turnaround-type arising opportunities (Sormani, 2004).

This is not to say that the typical seed investment and startup opportunities do not exist in developing economies.[6] However, in addition to the so far smaller percentage of innovative entrepreneurs in developing economies, other forces that would shift FVCs interest are at work. For one, FVCs lack the local networks and contacts that serve as a source of information on promising startups, reducing their visibility on FVC's radar of opportunities (White, Gao and Zang, 2002). This is especially pertinent for China[7] for example, where relationships act as a key to conducting business, and compensate for the lack of transparency in the market (Tsui, Lau, Schoonhoven, Meyer and Moilkovich, 2004).

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[6] *For example, India is a notable exception with a high number of investments attracted into young software firms.*

[7] *Another detriment, specific to China, would be the size of the country (Dauterive and Fok, 2004) presenting difficulties in both identifying opportunities as well as future monitoring and overseeing young entrepreneurs, additionally complicated by undeveloped communication (language barriers) and infrastructure.*

Visibility a side, another big problem in targeting innovative young entrepreneurs is lack of intellectual property rights (Zhou, 2002) and legal framework very much needed to protect that type of investment resulting in an increase of inherent high risk of such deals to unacceptable rates. Again, using the example of China, few VCs will finance startups, instead requiring the funded firm to have at least 3 years of financial documentation (Bruton and Ahlstrom, 2003). Using such screens in investee selection becomes necessary, due to few legal protections in developing economies against outright fraud, imperfect market information, and the rapid change of markets in general (Hoskisson et al., 2000).

Finally, seed investing results in a prolonged time of FVC's engagement before being able to exit the investment. Mantra of the U.S. VC industry has been to heavily invest in a relatively few truly outstanding companies, as early as possible, take them public as soon as possible, and raise more money (Bygrave, 2001). Idiosyncrasies of developing economies however often decelerate this process. For example, just the due diligence process in China usually takes 3 to 6 months longer compared with similar deals in the West[8] (Bruton and Ahlstrom, 2003). Thus, in order to keep the investment "lock in" time in acceptable ranges, FVCs would prefer to invest in later stage investments. To conclude, FVCs will tend to be much more conservative in their investing resulting in negligible investments in seed stage, focused instead on safer, later-stage ventures (Mitra, 2000).

4 Exit options in developing economies

A crucial part of venture capitalists' interest in an investment, even before the investors have paid money into a company, is considering how and when they will be able to reap the rewards of their investment (Balboa and Marti, 2003). In a developed market, venture capitalist's primary exit strategies are an initial public offering (IPO) or an acquisition of the company by its original founders or other investors. Although IPOs make for a preferred and most glamorous exit strategy for venture capitalists, as they carry highest return rates, even in developed

[8] *For example, Balboa and Marti (2004) report the due diligence process to be as short as two weeks in developed economies.*

economies the majority of VCs exits occur through trade sales (NVCA, 2004).[9] Some of the reasons given for preference of trade sales versus IPOs include that IPOs can be costly and time consuming compared to a trade sale, as well as the fact that an IPO requires appealing to an entire market instead of one buyer (Romaine, 2004). In developing economies, however, these reasons are only exacerbated by the institutional factors. Even if numerous innovative potential investees existed, the problems with exiting strategies would still alter the investment stage in favor of later stage ventures. Exiting strategies problems are in fact recognized as the biggest obstacle to creation of a vibrant VC industry (Dauterive and Fok, 2004) in developing economies.

Young and still undeveloped Stock Exchange or over-the-counter markets (Patricof, 1989) pose great difficulties for the feasibility of the IPO as an exit strategy. Stock markets of CEEs suffer from haphazard regulation and lack of liquidity (Romaine, 2001), and their overall lack of experience is further burdened by transition difficulties. For example in China, the two domestic stock exchanges (Shangai and Shenzen) favor state owned companies (Dauterive and Fok, 2004), and even more so, the state is the one to decide which companies can get listed on the exchange (Bruton and Ahlstrom, 2003). The role of the state, however much important in initiating the conditions enabling and facilitating VC industry development, often creates problems for FVCs' practices in every respect, and exiting options have suffered in the same way. In general, China's foreign investment rules were very rigid[10] and not well suited to the portfolio strategy that venture capital funds commonly use to spread their risk and capitalize on opportunities. In addition, those rules did not facilitate the kinds of exit mechanisms that venture capital funds depend on to realize on their investments. In India, government regulations such as prohibitions on companies buying back their shares added to restrictive

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[9] *This trend has primarily been seen due to the consequences of the internet bubble, characterized by easy exits. Venture-backed companies got a lot of public interest, and going public was easy as investors stood ready to buy newly issued equity at the time of the IPO. However, following the NASDAQ stock indices crash of 2001 and 2002, investor's appetite considerably decreased.*

[10] *Following China's enrollment to the WTO, China issued a new Regulation on the Administration of Foreign-Invested Venture Capital Enterprises, making a positive step toward development of China's VC market. However, it still failed to correct many problems carried over from the interim regulation. For example, the regulation does not sufficiently address investors' concerns about the transparency and accuracy of an investee company's books and records-requiring FVCs to spend significant time and money on due diligence, thus increasing transaction costs (Burke, 2003).*

climate for VC firms (Mitra, 2000). Another governmental restriction in India is evidenced in the contradictions of the regulatory system – venture funds need to adhere to three mutually inconsistent regulatory agents (Government of India, Securities and Exchange Board of India and Central Board of Direct Taxes) (Wright et al., 2002).

Complementing all the institutional weaknesses, one of the greatest strengths of developing markets is the immense size of their internal market for products, most of which is fundamentally untapped (Sorabella, 2000), resulting in increased attractiveness for foreign direct investment. As a result, we are witnesses of a growing number of acquisitions, joint ventures and alliances being formed between western corporations and developing economies' firms, collectively benefiting venture capitalists (Schwartz, 1994). The increase in strategic investments provides venture capitalists with more and better exit strategies[11] - ways for the initial investors to reap profits and yield their ownership or control to others. Paired with the unfavorable IPO circumstances, these factors further drive FVCs' frequency and preference in reliance on exiting by trade sales.

5 Role of FVCs in developing economies

Venture capitalists have played a critical role in the innovation process in the U.S. by providing funds and helping to organize embryonic technology-oriented companies (Florida and Kenney, 1988). Supporting this is the evidence provided by Kortum and Lerner (2000) who upon examination of 20 industries over 3 decades find that increases in venture capital activity in an industry are associated with significantly higher patent rates, with an estimate of VC activity accounting for 8 percent of industrial innovations in the period from 1983-1992. However, as opposed to the U.S., where venture capital emerged through an organic trial and error process, with the role of government being limited, in developing economies

[11] In the context of CEEs, it is widely expected that after EU accession, exit prospects in the region will improve further, due to increased interest of the foreign trade players to develop their business activities in the lower-cost, higher growth CEE economies; higher cross border activity by regions own corporations; improvements to the liquidity of domestic capital markets; decrease in the perceived risk in the region (EVCA, Special Report, 2004).

the governments still play a crucial role (Kenney et al., 2002) as a key initiator of VC activity.

In line with the long term country strategic goals, developing economies' governments founded affiliated organizations which provided funding for industries and regions deemed important for growth of the economy (Bruton and Ahlstrom, 2003; Burke, 2003) and often ended up tailoring policies which deterred the attractiveness of FVC entry or even prevented FVC investments all together[12] (Dauterive and Fok, 2004). Paired with undefined intellectual property protection and lack of exit options, FVCs investments in the few innovative start-ups are an exception rather than a rule. Although governments increasingly recognize the importance of FVC, and adjust their regulatory frameworks accordingly, the infant and small innovative sectors of the economy (seed investments ands start-ups) are still predominantly sponsored only by the government-affiliated organizations[13] in their effort to develop lacking entrepreneurial spirit and innovative activity within the country. As we have explained, the general dominant FVCs' stages of investment in developing economies are those of expansion (for example, in Czech Republic accounting for as much as 78 percent in 2001; EVCA, 2001), mezzanine or buyout finance [especially the case in CEE (Sormani, 2004)]. The sole prevalence of later stage investments already distinguishes FVCs in developing economies from the developed ones: despite optimistic forecasts, we believe that at least for the time being, their role will not be as emphasized in creation and integration of innovative firms of these economies as we are used to seeing in the U.S.

Although unfortunately, break-up data on stages of investments by domestic vs. foreign VCs is not available, we have shown that FVCs to mitigate the high risk involved with young start-ups or even seed investments, are investing primarily in later stage ventures. Anecdotal evidence also supports this logic. For example,

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[12] *For example, in China, foreign investors are prohibited or restricted in certain industries, such as basic telecom services, value-added telecom services, and the media. Adding to these complications, which investments are exactly restricted is loosely defined, and depends on government bureaucracy's interpretation, sometimes even on at the provincial or local level (Xiao, 2002).*

[13] *For example in Hungary, by 1996, two state owned innovation funds had essentially invested all their available funds and were constrained by a lack of profitable realizations from making further significant investments (Karsai et al., 1997).*

H&QAP, a private equity firm operating in Asia, (founded as a division of U.S. Hambrecht & Quist, one of the pioneers in venturing in Asia) prefers to invest more in the style of a buyout firm than a venture capital firm, as taking control of a company's majority ownership allows it to re-structure a company and to put in place a new management team (Borell, 2004) making for a faster exit and securing abnormal returns due to value added to the company. This investment pattern carries multiple implications for the role of FVCs in developing countries.

On a general note, VCs in addition to providing the financial capital to the investee, offer a full spectrum of services including market research and strategic advises, management consulting functions and management audit and evaluations, assistance in negotiations, help in establishing management and accounting controls, help in employee recruitment, counseling in complying with myriad of regulations and finally contacts with prospective suppliers, customers and other important business people and organizations (Kuratko, 2001). However, just as it has been shown for both CEE and Asian countries (Karsai et al., 1997; Pruthi et al., 2003) that FVCs differ significantly from domestic VCs in performing monitoring of investees, we believe the same context carries implications on the role of a FVC, on both micro and macro levels.

On the macro level, along with other VC funds in the country, the FVCs will first of all help mitigate the inadequate supply of finance in undeveloped financial markets. Faced with a growing number of new and newly privatized firms, the still emerging sector of banks and financial institutions was faced with high pressures, unable to fill the capital gap, resulting finally in the slowness in restructuring of the enterprises (Dockery and Herbert, 1996). Therefore, FVC presence is definitely welcome and invited for the role of equity finance providing, as both CEE (Eurostat, 2004) and Asian countries cite the lack of funds as one major constraint to innovation. What makes their contribution especially eminent, is that FVCs tend to be larger than domestic ones in terms of the size of funds they manage (Wright et al., 2002). Therefore, by expanding the market for private equity, VCFs have a major role in supporting economic transition in general and enterprise restructuring in particular (Dockery and Herbert, 1996). Not diminishing its importance, however, we are hesitant to emphasize solely the financial aspect of

their role. The other feature of their activities, those advice, management, and contact-based, should as well be given due attention.

One of the strengths FVCs have in contrast to domestic ones is the professional experience in financing and managing prior portfolio of investees[14] (White et al., 2002). More experienced venture capitalists, having seen many fledgling firms experience growth pains are able to provide valuable advice (Florida and Kenney, 1987). Consequently, they can leverage their knowledge and expertise in managing a VC cycle and decision making, adding more value to the company than a domestic VC could (Kenney et al., 2002). In particular, FVCs engage in more frequent requirement of financial reports by the investee than the domestic VCs and participate more often in board meetings and visits to the company's premises, making sure that the operational activities of the firm are flowing according to the plan, thus adding more value to the firm (Sapienza, Manigart and Vermeir, 1995). Domestic VCs lack of involvement with investee's management can be interpreted as a lack of learning about what makes a good management team, which would in effect influence the development of the tacit knowledge so important in judging the true quality of a management team prior to investment; and finally decrease the potential value added to the firm.

In addressing advice giving, it is important to understand that the nature of advice differs from those of developed economies. Although there are more and more reports of elimination of less competent managers from developing countries' firms (Sormani, 2004), the fact remains that managers are still adapting to the free market systems, and those leaders of enterprises that remained from "old" systems are often deemed inept. One of the extreme examples includes an experience of a FVC in China, where there was a need to teach managers the basics like valuing their firm beyond the hard assets possessed and appreciating other aspects like brand value, distribution systems in place, and importance of business partners (Bruton and Ahlstrom, 2003). Also, these managers are often ignorant of GAAP,

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[14] *In fact, besides the experience on a more global level, studies have found significant differences in the number of years FVCs have been involved in venture capital. This difference ranges from 2 years (Pruthi et al., 2003, India) to more impressive difference of 9 years found by Zhang and Jiang (2002). These authors found that managers in domestic VC firms averaged 2.1 years of relevant experience, while those of FVCs operating in China averaged 11.9 years.*

short term financing, and alike, making the role of the FVCs a crucial one in transfer of what is in the developed economy considered common knowledge. In their pursuit to exit the investment, FVCs will do their best to improve existing management, operations, but also strategic issues in order to "package" the firm for a trade sale, or less often, an IPO. As opposed to for example joint ventures, where foreign partners are often hesitant to disclose their tacit knowledge, it will be in FVC's best interest to inject this knowledge in an investee. This way, we believe FVC's important role in developing economies to be in closing the gap between developing and the developed economies of the West (Bruton and Ahlstrom, 2003, McKnight and Parker, 2001).

As we discussed the difficulties of exit options available and viable in developing economies, we will extend the discussion here to see how planned exiting strategies influence the role of FVCs. Despite differences in Stock Exchange sophistication among developing countries, exiting by trade sale is still the easiest alternative for investors (Zhou, 2002) across them. For example, in Hungary, year 2000 saw 57.1 percent trade sale exits, Poland had a percentage as high as 85 percent (EVCA, 2001). This especially holds true for foreign investors (Bruton and Ahlstrom, 2003). Since FVCs have developed networks of corporate contacts in developed countries, it is likely that these contacts will be the primary candidates as strategic buyers. This way, FVCs become dependent on corporate strategies as their exit routes, having in turn a strong influence on their selection mechanisms. As FVCs plan and calculate the probability of exit into the initial evaluation of the investee, it is easy to see how corporate contacts could introduce bias into criteria a FVC uses in picking the companies to invest in. Therefore we presume that only the companies that would enhance or fit into corporate portfolios will get a chance for FVC financing. On the positive note, this would imply higher potential for internationalization of developing country's companies. Even before the trade sale occurs, the internationally connected venture capitalists can serve their portfolio firms by providing contacts and information about opportunities in other countries. It is the venture capitalists' experience and connections that differentiate them from other sources of capital. For example, one manager in China praised his FVC for connecting the firm with another firm in India, enabling them to reduce their operating costs and improve efficiency; as well as connecting them with a strategic partner in the U.S., helping the firm to internationalize and enter

the high potential market (Bruton and Ahlstrom, 2003). This example implies another important role of FVCs, manifested in the process of connecting their investees with foreign partners. The act of committing resources and time to the investee in a developing economy signals the quality of the firm, its products and management to international partners, increasing not only its visibility, but more importantly its legitimacy in the international arena.[15]

On a more negative side, however, if there is a lack of diversity in the potential corporate exits, then this may lead to a strong bias toward a particular type of investees. Another potential source of bias in both the selection mechanisms of investees and identifying candidates for trade buyers is FVC's lack of local corporate contacts in developing economies. Providing there are interested local corporations missed as potential strategic buyers, FVCs would deter the integration process of companies in local production networks. This would be particularly relevant for the case of China, where *guanxi* make a part not only of the business culture (Tsui et al., 2004), but a resource in terms of sourcing new deals, as well as successful exiting given the right relationships are in place (Bruton and Ahlstrom, 2003).

Having introduced the importance of the process of selection, and the potential bias specific to FVCs, we have to raise a more general question of its efficiency. In newly privatized economies, the market is just starting to act as a selection mechanism, in terms of filtering the firms based on their capabilities and value they add to the customers. Seen this way, appearance of VC acts as another device in the selection apparatus, or another way to distribute the resources. One can presumably say that VCs would be more efficient in doing this than the governments, but the question arises if it is more efficient than the market. As an example, let us remember the big bubble burst of the dot-coms, where the frantic choices of VCs proved ineffective. To what extent did the VCs get burnt and managed to learn from this experience (evidenced by more cautionary investments in the U.S.), and how this applies to their selection choices in developing

[15] *It would be particularly interesting to examine this process in the context of CEE, as we can presume that the persistent efforts to deeply integrate the accession countries into the EU would benefit from this effect. Likewise, it is plausible to presume that integration would be facilitated by the convergence of legal and monetary systems within the region.*

economies, remains an interesting question for future research, as given the recent occurrence of this event, it is too early to judge at this point.

Finally, after recognizing the role of FVCs in selection, internationalization, value adding to developing economies' enterprises, it is necessary to address their role in knowledge transfer not only to the investee, but to other actors in the VC industry – domestic venture capitalists per se. There is much to be learned from the expertise FVCs bring into developing economies, in terms of evaluating and selecting promising investees, as well as adding value to the firm once the decision of investing has been made. The often criticized inefficiency of government-related interference in venture capital, evidenced by bankruptcies of some affiliated domestic VC firms (White et al., 2002) speaks for itself on the learning that still must take place. On the other hand, we do not claim that FVCs are a panacea for developing economies context, or that their knowledge on behavior in these special circumstances is perfect. The same learning argument can be placed for the FVCs as well, as we must not forget the institutional aspects that influence FVCs operations and ultimately success. Lack of embeddedness in local networks, and the need for establishing relationships with local governments, corporations and universities poses a challenge for the future. Likewise, softer issues like understanding the social frameworks, culture, importance of relationships, represents a must have for FVCs. There is still a lot of learning on both parts yet to take place in developing economies. To what extent it will yield success, and start resembling the western concept of recognized role of VCs are facilitators of lucrative innovations and economic growth, remains for the time to tell.

6 Conclusion

Before giving a concluding word on the role of FVCs in developing economies, a few areas of concern must be acknowledged. Firstly, in bringing forth suggestions for roles of FVC we were faced with a lack of empirical data to support the propositions set forth in this paper. Secondly, we recognized the problem of definitional ambiguity regarding the notion of venture capital and private equity. It has been noted that not only do the methodologies and definitions differ

among Venture Capital Associations as primary (and often only) sources of data across regions and countries, but this lack of clarity has spilled over to the academic literature as well. Finally, the extent to which FVCs will play a specific role in a developing country will necessarily be contingent upon the idiosyncrasies of each country's historical development, regulation system and phase of transition process. Hoskisson et al. (2000, p. 259) warn us that *"it must be recognized that emerging / transitional economies are not homogeneous, even within the same geographic region, thus any tentative generalization must be taken with caution, keeping in mind the unique aspects of each country's transition specificities."* However, every limitation invites further exploration in future research and developing economies still present us with a challenge of firstly understanding the dynamics taking place in those countries, and upon resolving the definitional issues, testing the applicability of western theories and models in these unique settings.

Having acknowledged the possible limitations, we still believe that however tentative, conclusions of this study shed some light on the role of foreign venture capitalists in developing economies. Overall, we can conclude that despite increasing rates of entrepreneurial activities, accompanied by economic liberalization and government efforts to set up institutional frameworks benefiting innovation and foreign venture capital investment, the role of FVC will first serve as a (1) selecting mechanism identifying high potential companies, (2) knowledge transfer mechanism, especially in management related issues, reducing the gap between western and developing economies practices (McKnight and Parker, 2001) both in the economy in general, as well as VC industry in particular, (3) networking mechanism, helping both host countries' companies to internationalize and developed firms to tap into developing markets. Only once all the institutional frameworks become conducive to facilitating venture capitalist's operations as seen in the U.S. for example, can we expect the practice of venture investing to encourage the "proper" type of entrepreneurship, and initiate the "start up" culture (Kenney, Han and Tanaka, 2002) we typically envision when talking about the role of VC investment in the Western context.

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