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Distant VCs and IPO performance Jiajia Wu, Carl R. Chen & Ying Sophie Huang

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ABSTRACT

performance of entrepreneurial firms. We propose that 'distant' VCs are more likely to suffer from information asymmetry, which may decrease their effectiveness in monitoring and adding value. This, in turn, could lead to higher uncertainty and more severe underpricing in entrepreneurial firms. Our analyses show greater institutional, cultural, and geographical distances are associated with higher IPO underpricing, while institutional and cultural distances have a greater impact than the more understood geographical distances. The adverse effects of distance are amplified for VCs with weaker investment networks and for IPO firms located in regions with a lower degree of marketization, where access to critical information and resources is constrained. Our main findings continue in a propensity score matching analysis, instrumental variables approach, and other robustness checks. Additionally, we provide evidence that these distances, particularly institutional distance, negatively impact post-IPO market performance,

cultural distance

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reinforcing the notion that various distances diminish VCs' effectiveness.

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Disclosure statement

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mitigate the confounding effects introduced by foreign VC, we exclude foreign VC

Notes

involvement, both alone and in partnership with domestic VCs. Additionally, we omit IPO companies lacking essential data, resulting in a final sample of 690 VCbacked IPO firms for our study. ² The CPMI includes five components: (1) the relationship between government and market, mainly indicating government intervention and government efficiency; (2) the development of a non-SOE economy; (3) the development of product markets; (4) the development of factor markets; and (5) intermediary

organization development and legal environment. These components measure

different aspects of a province's marketization assessed by the NERI. The CPMI is

¹ Due to data limitations on VC investments, our sample ends in 2018. To ensure

consistency in the measurement of institutional and cultural distances, and to

- the average of these five components. More details about the CPMI can be found in X. Wang, Fan, and Hu (<u>2019</u>). ³ For multiple VC investors, we focus on the institutional distance of the lead VC to the investee firm, as lead VCs handle most due diligence and oversight activities. The lead VC is defined as the one with the largest cumulative investment or, in cases of a tie, the earliest investor (Nahata, Hazarika, and Tandon 2014). This approach also applies to measuring cultural and geographical distances. In an untabulated analysis, we define the lead VC investor as the one who participated in the most financing rounds and was also involved in the initial financing round of
- alternative definition yields similar results. ⁴ The survey collected a total of 4,929 questionnaire responses, of which 3,690 were valid. The survey encompassed 56 universities across various provinces, municipalities, and autonomous regions (excluding Hong Kong, Macau, and Taiwan), including '985' and '211' universities, as well as ordinary universities and vocational colleges. ⁵ Due to the suspension of IPOs throughout 2013 in China, combined with missing

the IPO firm (Megginson and Weiss 1991; Sørensen 2007). If multiple lead VCs

meet this criterion, we select the one with the highest total investment. The

⁶ Principal component analysis (PCA), as introduced by Hotelling (<u>1933</u>), allows us to isolate the principal components of our three distance variables. PCA identifies the linear combination of the original distance variables that accounts for the

largest possible variance, thus capturing as much of the data's variability as

possible. This method enables us to discern the impact of the most significant

values for key variables, no observations are available for that year.

'common element' shared by all distance measures. The first principal component, a nearly equal-weighted linear combination of all three distance variables, accounts for 73% of the total variance. ⁷ Orthogonalization is achieved using the modified Gram-Schmidt process (Golub and Van Loan 1996). This transforms our three independent distance variables into a mutually orthogonal set of transformed distance variables, preserving the original three-dimensional subspace. This allows us to capture the unique impact of each distance dimension, uncorrelated with the others. We use the order:

institutional distance, cultural distance, geographical distance, but alternative

250 are located outside these hub cities. Among the VCs located in hub cities, 75% of their invested IPO firms are located outside their home province. In contrast, only 32% of the IPO firms backed by VCs outside of hub cities are located in different provinces. This suggests that VCs in hub cities tend to invest in distant locations compared to their counterparts in non-hub cities. ⁹ Specifically, this method utilizes the Chinese Dialect Family Tree from the Language Atlas of China (Chinese Academy of Social Sciences, and Australian

Academy of the Humanities 1987) and the Dictionary of Chinese Dialect (Xu and

Ichiro 1999). Chinese dialects are classified into ten dialectal super groups,

⁸ In our sample, 533 VC firms are located in Beijing, Shanghai, or Shenzhen, while

namely, Mandarin, Wu, Gan, Xiang, Min, Hakka, Yue, Jin, Ping, and Hui. Each super group can be further divided into several smaller, i.e. second-tier dialectal groups, based on tonal categories and pitch contour. The smallest dialectal unit is the dialect sub-group. Each county (the smallest administrative division) typically has a unique dialect. Following the methodology of Y. Liu, Jiao, and Xu (2020), we calculate dialect distance between cities, which ranges from 0 to 3, with higher values indicating greater dialect distance between two cities. **Additional information Funding**

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orderings yield similar results.

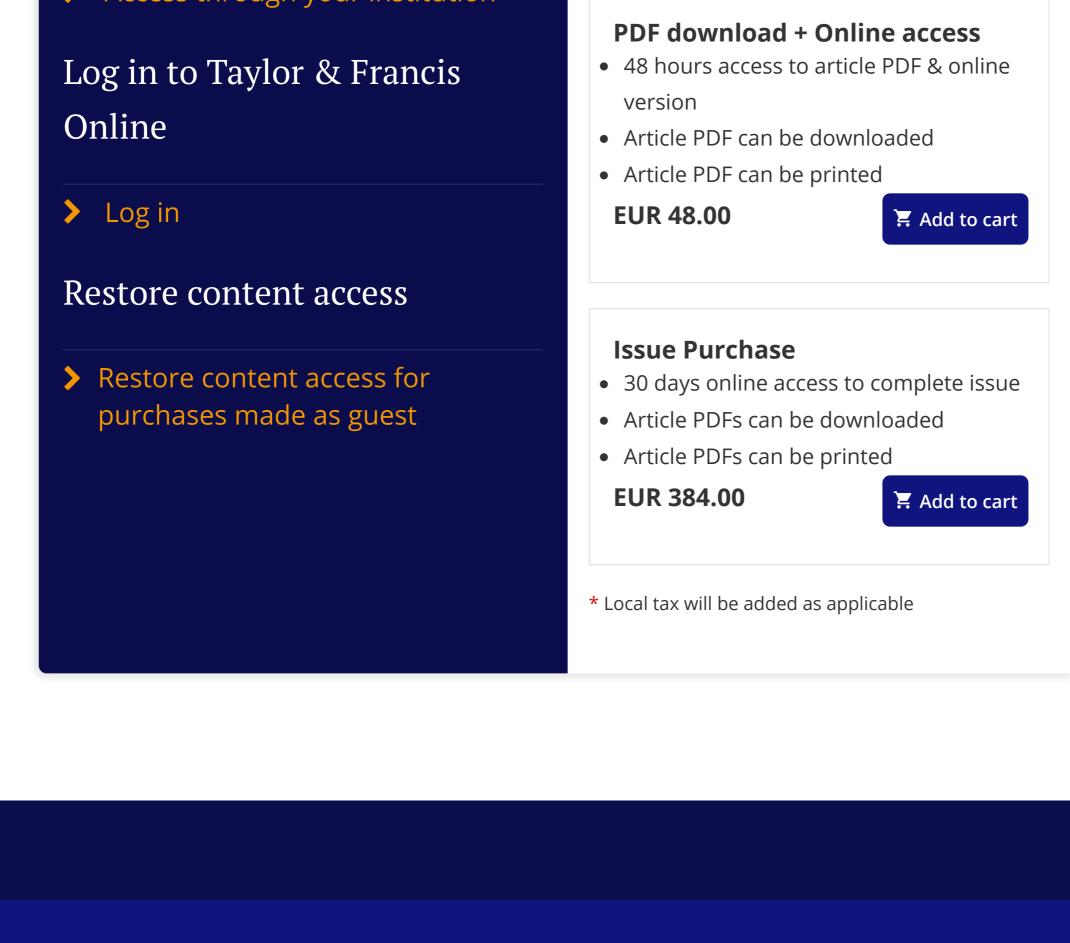
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