

Breaking Through the Great Wall of Guanxi

*How Western venture capitalists initiate and build guanxi
with founders of Chinese startups*

619 Thesis in Management and 649 Thesis in Finance

Abstract

China is one of the world's fastest growing markets for venture capital investments, spurring Western venture capitalists' interest to invest in the region. However, China's institutional environment makes it difficult for Western venture capitalists to execute their due diligence. Transparency and reliability of information is low, and due to cultural norms Chinese founders are unwilling to share information with people they do not have established relationships with, or as the Chinese state it, *guanxi* with. Guanxi refers to a personal connection between two individuals, who follow the social norm of guanxi such as doing favors for each other. For a venture capitalist in China, possessing guanxi with founders becomes important to receive information during the due diligence process.

Hence, this study explores how Western venture capitalists initiate and build guanxi with founders of Chinese startups during the due diligence process. This thesis tests *A process model of interpersonal guanxi development* through a qualitative study in a Chinese venture capital setting, to see if and how the model is applicable. A revised model, *A process model of the venture capitalist's guanxi development*, is proposed.

In the initiating stage of guanxi, the objective for the venture capitalist and the founder is to identify commonalities that will be claimed as bases for developing guanxi. This study finds that venture capitalists mitigate risk through meeting with founders that they have been referred to by a third party, whom both parties have guanxi with. Hence, *common third party* is the most frequent guanxi base. Moreover, the venture capitalists involve other people that can reveal and verify the guanxi bases. Hence, *background check actors* are added in the revised model that support the initiating stage. In the building stage, the objective is to enhance quality of guanxi. This thesis finds that two of the factors leading to quality guanxi, *sincerity and obligation*, arises naturally when the venture capitalist and the founder are introduced by a common third party. The remaining two factors, *ability and affection*, the venture capitalist should actively demonstrate to establish guanxi with the founder.

From a management perspective, this thesis concludes that an effective strategy to initiate and build guanxi is to establish a guanxi network of third parties that can provide referrals. This facilitates the process of developing guanxi on an interpersonal level with the founders.

Keywords: *Venture Capital, Guanxi, Relationship Development, China*

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“It doesn’t matter how smart you are, how much money you have or how great you are at picking the best companies. If you don’t have the relations in China - you are screwed.”

- Harry, Partner at Matrix Partners China

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Definitions

Concept	Definition
Due diligence process	The stage when the venture capitalist evaluates a potential investment, prior to signing a contract to invest (Camp, 2002). This usually includes reviewing the company's organization, history, management, employee relations, financials, accounting, contracts and legal matters (Yang, Zhou and Zhao, 2013).
Founder	The person that has founded the startup that the venture capitalist potentially wants to invest in. When discussing the potential investment opportunity this is done between the founder and the venture capitalist.
Guanxi	A Chinese term referring to a personal connection between two individuals. The two individuals are bounded by an implicit psychological contract to follow the social norm of guanxi such as maintaining a long-term relationship, mutual commitment, loyalty, and obligation (Chen and Chen 2004).
Information asymmetry	When one party possesses greater knowledge than the other party (Bruton and Ahlstrom, 2003). In this thesis, the information asymmetry referred to is that the founder has more information regarding his/her background and the business of his/her startup than the venture capitalist has.
Startup	An early stage company with high growth potential. To finance its growth, a startup can search for financing from venture capitalists.
Venture capital	The activity of investing funds raised from institutional investors, or wealthy individuals, into early stage companies with growth potential (Gompers and Lerner, 2001).
Venture capitalist	An investor who provides capital to startups. In this thesis, a venture capitalist will refer to a person working at a venture capital firm.
West	The geographical areas of Northern America and Western Europe (Bruton and Ahlstrom, 2003).
Western venture capital firm	A venture capital firm with origin from Northern America and/or Western Europe (Bruton and Ahlstrom, 2003).
Western venture capitalist	A venture capitalist with origin from Northern America and/or Western Europe (Bruton and Ahlstrom, 2003).

Table 1 Definitions

1. Introduction

1.1 Background

Venture Capital was first initiated in the United States of America in year 1946, and came to China in the early 1980's (Gompers and Lerner, 2001). Since then, China has evolved into one of the world's fastest growing markets for venture capital investments. The United States of America is still the greatest market for venture capital, receiving total investments of 69 billion dollars in 2016 (EY, 2016). However, China is catching up with a funding of 30 billion dollars raised during the same period (KPMG, 2017).

Venture capital investments have increased dramatically in China during the last five years. In 2016, venture capitalists made six times more deals compared to in 2012 and the deal values have grown to be five times the size (PWC, 2016). The gradual shift from a manufacturing economy towards a consumer and services-led economy is fostering entrepreneurship in China, and is expected to drive further growth of venture capital in the country. Consequently, the Chinese venture capital market is highly interesting for venture capitalists (KPMG, 2017). The high growth of venture capital in China is drawing foreign venture capitalist's interest, among them Western venture capitalists. The United States of America stands for the largest part of investors approaching the region (EY, 2016).

However, entering the Chinese market and doing investments in China is not straightforward for Western venture capitalists (Ahlstrom, Bruton and Yeh, 2007). A difficult part of the investment process in China is conducting due diligence. In the due diligence process, the venture capitalist evaluates the startup that it is considering investing in before making a deal. The due diligence is challenging in China since information is not as accessible or reliable as in the Western countries. Moreover, due to cultural norms of not sharing information with strangers, Chinese founders are unwilling to share information with venture capitalists that they do not have an established relation with. Hence, venture capitalists need to spend a lot of resources to receive the required information (Bruton and Ahlstrom, 2003).

In China, relations are highly relied on, known as the Chinese concept *guanxi*. Guanxi refers to a personal connection between two individuals, who follow the social norm of guanxi such as maintaining a long-term relation and doing favors for each other (Chen and Chen, 2004). In Chinese business, having guanxi with key individuals is a critical success factor (Bruton and Ahlstrom, 2003). Western managers working with Chinese organizations need to realize that it is challenging, if not impossible, to be impersonal in China to succeed. The right question is not whether, but *how* one should develop guanxi (Chen and Chen, 2004).

To overcome the challenge of receiving information in the due diligence process, the venture capitalist can engage in establishing *guanxi* with the founder. By having guanxi with the founder, the founder will provide the venture capitalist with more information regarding the investment opportunity. This will help reduce the information asymmetry between the two parties. Building these relationships can be time-consuming, expensive and difficult, though thought to be necessary in order to value the potential deal and make a proper investment decision (Bruton and Ahlstrom, 2003). Hence, this thesis research question is:

How do Western venture capitalists initiate and build guanxi with founders of Chinese startups during the due diligence process?

1.2 Previous Research

Within the field of institutional theory, previous research has pointed out that China's institutional environment creates challenges for Western venture capitalists. In the due diligence process in specific, the main challenge is getting access to relevant and reliable information about the founder and the founder's startup. Firstly, China's accounting practices differ from international practices and the accuracy and transparency of information is often low. Secondly, it is part of Chinese culture that individuals do not share information with those they do not have an established relationship with (Bruton and Ahlstrom, 2003).

To overcome the challenges in the due diligence arising because of China's institutional environment, Western venture capitalist can engage in building *guanxi* with the founder of the startup they are considering investing in. By having *guanxi* with the founder of interest, he or she can provide the relevant information (Bruton and Ahlstrom, 2003).

Within the field of *guanxi*, previous literature has widely recognized the importance of having *guanxi* in Chinese business and the complexity of the concept (Chen and Chen, 2004). However, research on *how* *guanxi* between two individuals is developed has been limited. In 2004, Chen and Chen brought attention to how *guanxi* is created by proposing *A process model of interpersonal guanxi development*. The model divides *guanxi* development into three stages: the *initiating* stage, the *building* stage and the *using* stage. Each stage has its own objective, activities to reach the objective and principle that underlies the activities.

1.3 Research Gap

In the limited research area of how *guanxi* is developed, the major weakness is that the theoretical models have not been empirically tested (Chen, Chen and Huang, 2013). As Chen and Chen (2004) points forward, *A process model of interpersonal guanxi development* must be tested. To test the model, the authors state that researchers should choose a research site where *guanxi* has been formed from scratch, through personal interactions between previous strangers. The authors make a few suggestions of research sites: organizations that have had a high mobility of people or Chinese-foreign joint ventures in high-tech.

To this thesis knowledge, Chen and Chen's model has yet not been tested. To fill this gap in the *guanxi* research field, this thesis aims to test the model. The research site chosen is the venture capital market in China. In specific, the *guanxi* development that will be studied is between Western venture capitalists operating in China and Chinese founders of startups. The timeframe of the *guanxi* process studied is during the due diligence. This research site is expected to fulfill Chen and Chen's criteria of *guanxi* being developed from scratch, since, 1. the Western venture capitalists have entered a market that is new for them and, 2. they presumably do not have an established *guanxi* with the startups before the due diligence.

Additionally, in the research field of *guanxi* within venture capital one weakness is that the question of *how* *guanxi* is built with founders has not been explored. However, the vitality of building *guanxi* with founders for venture capitalists to receive information during the due diligence process has been emphasized (Bruton and Ahlstrom, 2003). This thesis will therefore study this unexplored research area on *guanxi* within the Chinese venture capital market.

1.4 Purpose of Thesis and Research question

The purpose of this thesis is to examine how Western venture capitalists, operating in China, initiate and build guanxi with Chinese founders of startups they are considering investing in.

This thesis aims to test *A process model of interpersonal guanxi development* on Western venture capitalists' relational development with founders of Chinese startups during the due diligence process. The model is tested to evaluate if and how it is applicable in the Chinese venture capital setting. The study intends to answer the following research question:

“How do Western venture capitalists initiate and build guanxi with founders of Chinese startups during the due diligence process?”

1.5 Limitations

As Chen and Chen (2004) highlight, *A process model of interpersonal guanxi development* is extensive and might not be possible to test in one study. However, since each stage has its distinct principle and objective the authors propose that a study could be limited to testing one or two stages of the model. This thesis will follow the author's suggestions, testing the first two stages: the *initiating* and *building* stage. The *using* stage will not be explored.

Another limitation is that this thesis will study the guanxi development process through looking at the actions of the venture capitalist. Guanxi is a relation where two parties, the venture capitalist and the founder, influence the process of guanxi development. Preferably, one would therefore study the process from both parties' side. Due to the thesis limitations in time and size, studying the founder's actions will however be out of scope. Moreover, it will not examine how the founders experience the venture capitalists' efforts of initiating and building guanxi with them. The process will only be studied through the lens of the venture capitalist.

Additionally, the thesis is limited to studying *Western* venture capitalists (see *Definitions*). The study will geographically be limited to Western venture capitalists active in Shanghai and Beijing. Beijing is the leading area for Chinese venture capital and the city in China where most capital is raised, followed closely by Shanghai (EY, 2012).

1.6 Assumptions

A process model of interpersonal guanxi development describes how two individuals, who previously are strangers, establish guanxi with each other. It is noteworthy that the model focuses on *voluntary ties*, which are guanxi ties formed voluntarily from scratch, in contrast to predetermined ties such as family ties. Hence, the individual has the freedom to enter and develop relationships (Chen and Chen, 2004). One assumption made is therefore that the venture capitalists have no pre-existing guanxi relationship with the startup's founders.

Moreover, although the *using* stage in the model will not be tested, this thesis recognizes that this stage is highly important for motivating the relevance of studying the first two stages of the model. The using stage is when both individuals have quality guanxi and can receive benefits and ask for favors. In this thesis, it is assumed that the benefits for Western venture capitalist is being able to ask for and receive a higher degree and/or quality of information from the founder during the due diligence process. The information referred to is information that is relevant to evaluate the potential deal.

2. Theory

In this section, a literature review within three theoretical areas are presented: *Venture Capital*, *Institutional factors influencing the due diligence process* and *Guanxi*. Moreover, the theoretical framework *A process model of interpersonal guanxi development* is introduced.

2.1 Venture Capital

2.1.1 Characteristics of Venture Capital and the Due Diligence

Venture Capital is defined as the activity of investing funds raised from institutional investors, or wealthy individuals, into promising new companies with growth potential. The companies that venture capitalists invest in are generally considered as high risk due to their early stage, however, in compensation they can generate high returns (Gompers and Lerner, 2001).

During the typical lifetime of ten years for a fund, the investment process for the venture capitalist is defined as a four-stage process. 1. *Deal generation*: searching for potential deals. 2. *Due diligence*: evaluating potential deals. 3. *Monitoring*: making sure portfolio companies are performing in line with goals and helping through value-adding activities. 4. *Exit*: selling its shareholdings to another owner. This thesis will focus on the second step, *due diligence*, in the four-stage investment process (Klonowski, 2013).

A due diligence process is defined as what the venture capital firm does to evaluate a potential investment, prior to signing a contract to invest (Camp, 2002). To evaluate the business opportunity and assess the risk of making an investment, venture capitalists rely on financial and accounting information (Wright, Thompson and Robbie, 1992). Due diligence usually includes reviewing the portfolio company's organization, history, management, employee relations, financials, accounting, contracts and other legal matters (Yang, Zhou and Zhao, 2013). In the due diligence process, the venture capitalist seeks to validate the information that the firm submits (Bruton and Ahlstrom, 2003).

2.1.2 Challenges in Due Diligence Due to China's Institutions

Institutional theory argues that institutions shape the actions of firms and individuals (Bruton and Ahlstrom, 2003). Institutions can be categorized into regulatory, normative and cognitive institutions. Regulatory institutions are the most formal, representing standards provided by laws. Normative institutions are less formal, defined as actions that are expected of individuals and are manifested through accepted authority systems as for instance accounting. Cognitive institutions are the most informal, taken-for-granted rules and beliefs that are established among individuals through social interactions (Scott, 1995). A common mean of how cognitive institutions influences a society is through the society's culture (Jepperson, 1991).

China's institutional environment is quite different from the Western countries' and creates several challenges for Western venture capitalists. Firstly, China's regulations do not require that the same level of public information to be provided which results in transparency of information being low. Secondly, the normative standard for the country's accounting practices deviates from what is generally accepted internationally. Thus, it can be difficult to obtain accurate or useful information about the startups performance (Broadman, 1999; Peng, 2000).

Thirdly, cognitive institutions hinder gaining information about the founder of the firm. In Chinese culture, it is uncommon for individuals to share information with people they do not have an established relation, *guanxi*, with (Goa, Ting-Toomey and Gudykunst, 1996; Wank, 1996). Hence, to get the founder to open up and provide information the venture capitalists have to build *guanxi* with the founders of interest (Bruton and Ahlstrom, 2003).

When Western venture capitalists first entered China in the beginning of the 1980's, due diligence for funded projects was extremely limited since it was very hard to conduct (Bruton et al., 1999; Mann, 1997). Since then, venture capitalists have increased their efforts to be able to conduct the due diligence. However, as previously mentioned, the availability and accuracy of information still poses problems in the process (Bruton and Ahlstrom, 2003).

2.2 The Concept of Guanxi

At *guanxi*'s root lies that unwritten social rules, cognitive institutions, are far more relied on than regulatory and normative institutions in China (Bruton and Ahlstrom, 2003). There is a debate among researchers about the prevalence of *guanxi* in Chinese society; some believe it is a result of weak regulatory institutions and that its significance will reduce in pace with that these institutions are strengthened (Xin and Pearce, 1996), while others argue that *guanxi* is deeply rooted in Chinese culture and not transitory (Fei, 1992).

Guanxi is a complex concept because it has many different definitions (Chen, Chen and Huang, 2013). *Guanxi* is generally conceived as a resource that can be traded on when needed, however it can also represent a liability if a favor is owed (Tsang, 1998). The word *guanxi* itself does not mark the unit studied; it can refer to both one *guanxi* relation and a net of several *guanxi* relations (Chen, Chen and Huang, 2013). There are two main perspectives in previous research: the network perspective, that explores *guanxi* on the network level (e.g. Bian, 1997; Fried, 1954), and the dyadic perspective, which focuses on the relations between two specific actors (e.g. Yang, 1994; Alston, 1989).

This thesis will adopt the definition of *guanxi* as: *"A personal connection between two individuals who are bounded by an implicit psychological contract to follow the social norm of guanxi such as maintaining a long-term relationship, mutual commitment, loyalty, and obligation"* (Chen and Chen, 2004). Chen and Chen take a dyadic approach, arguing that the fundamental unit of *guanxi* is the dyad. Acknowledging that *guanxi* at a network level exists, they argue that *guanxi* at the network level is made up by interpersonal *guanxi* dyads.

In an organizational setting, *guanxi* has been conceptualized as *guanxi strategies*, referring to when employees build and use personal connections to enhance performance (Park and Luo, 2001). *Guanxi strategies* have shown to have several positive effects for organizations, both on market performance and financial performance (Luo, Huang and Wang, 2012).

2.3 A Process Model of Interpersonal Guanxi Development

The theoretical framework used in this thesis is *A process model of interpersonal guanxi development* (Chen and Chen, 2004), presented in Figure 1.

When overviewing the literature on guanxi, researchers have previously highlighted a few weaknesses. Firstly, although the importance of guanxi in the Chinese society has been underscored, the actual building and operationalization of guanxi has not been accounted for. Another weakness in the existing theories is that the guanxi models tend to be static, not addressing how guanxi is initiated, developed, and changed over time (Yang, 2001).

To address these shortcomings in the guanxi research field and complement the field's main interest in guanxi consequences with a new focus on guanxi development, Chen and Chen proposed the model *A process model of interpersonal guanxi development* (2004). Like mentioned, the model divides guanxi building into three stages, *initiating*, *building* and *using guanxi*. At each stage three sets of variables are examined: (1) guanxi objectives that are to be reached through interactive activities, (2) interactive behaviors and activities of potential and actual guanxi parties, and (3) operating principles that underlie the interactive behaviors and moderate the relationship between these behaviors and guanxi objectives.

A process model of interpersonal guanxi development

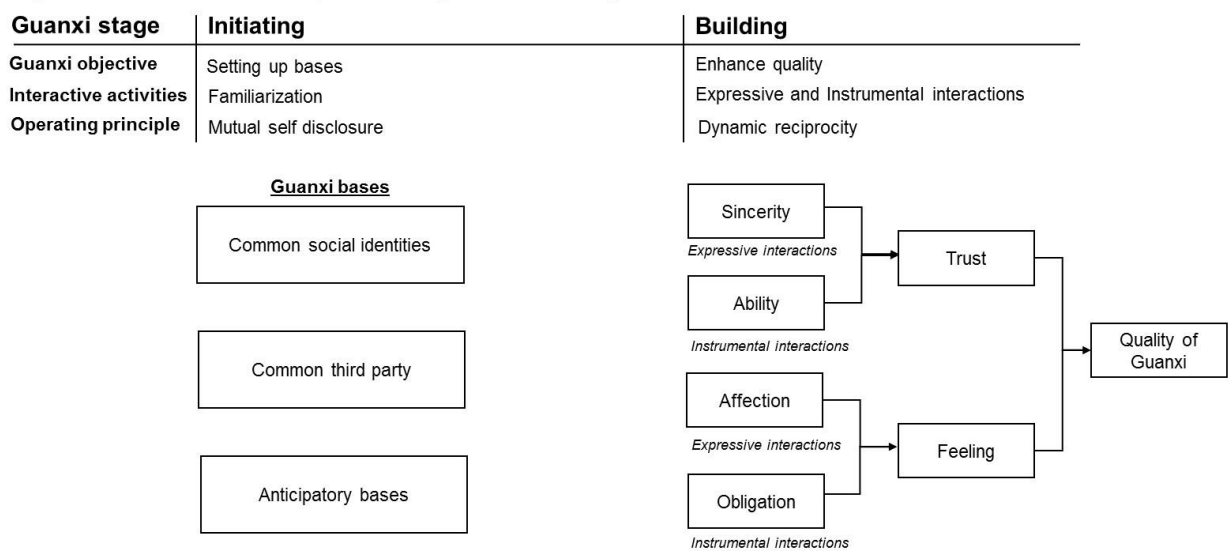


Figure 1 A process model of interpersonal guanxi development

2.3.1 The First Guanxi Stage: Initiating

In the Guanxi stage *initiating* the guanxi objective is *setting up bases*, the interactive activity is *familiarizing* and the operating principle is *mutual self-disclosure*.

2.3.1.1 Guanxi Objective: Setting Up Bases

The guanxi objective for the *initiating* stage is *setting up bases*. Guanxi bases are the relational ties between two individuals. One point to notice regarding the bases is that they are not mutually exclusive; the two individuals can have several guanxi bases.

The first guanxi base is *common social identities*, which are birthplace, educational institution and workplace. The second guanxi base is *common third party*. The base refers to when two individuals who do not have direct guanxi with each other still can claim to have guanxi since they have been acquainted through a common third party, with whom they both have guanxi. The third guanxi base is *anticipatory bases*, which are future oriented and are created through expressing an intention or promise to engage in future collaborations.

2.3.1.2 Interactive Activity: Familiarizing

The interactive activity for the initiating stage is *familiarizing*. Through an activity of familiarization, two individuals who are strangers to each other identify or create commonalities that will be claimed as guanxi bases for future interactions. The individuals become familiar with each other by comparing and trying to relate their own personal backgrounds.

2.3.1.3 Operating Principle: Mutual Self-disclosure

The operating principle during the initiating stage is *mutual self-disclosure*. Mutual self-disclosure is to what extent the two individuals reveal personal information to each other. The extent of self-disclosure will affect how many guanxi bases that will be discovered. Hence, both individuals must be willing to take and respond to self-disclosure initiatives.

Failure to reciprocate self-disclosure is a sign of not wanting to initiate the relationship. One factor that adds to the complexity of the principle is cultural differences in level of self-disclosure. Cross-cultural observations have shown that Chinese individuals in general tend to share less personal information with strangers than Western persons do.

2.3.2 The Second Guanxi Stage: Building

In the Guanxi stage *building* the guanxi objective is *enhancing quality*, the interactive activities are *expressive and instrumental interactions* and the operating principle is *dynamic reciprocity*.

2.3.2.1 Guanxi Objective: Enhancing Quality

The guanxi objective in the building stage is *enhancing quality*. Guanxi quality assesses the state of the relationship at a given point in time. The guanxi quality is determined by *trust*, which is composed of *ability* and *sincerity*, and *feeling*, which in turn is composed of *affection* and *obligation*. The higher the level of trust and level of feeling, the higher quality of guanxi.

The first factor generating trust is *sincerity*. Sincerity means that an individual has the other parts best interest at heart. The second factor generating trust is *ability*. Ability refers to an individual's competence or expertise in specific domain areas.

The first factor generating feeling is *affection*, which refers to the degree of emotional understanding and connection. The second factor generating feeling is *obligation*, which refers to the indebtedness that results from social and economic transactions. Obligation is described in terms of amount and depth due to a long exchange history or a wide scope of exchanges.

2.3.2.2 Interactive Activities: Expressive and Instrumental Interactions

The interactive activities for the building stage is *expressive and instrumental interactions*, which are the two types of personal interactions. These interactions aim at improving the quality of guanxi. Expressive interactions refer to social-oriented activities, for example having dinner. Instrumental interactions refer to exchanges related to business, for instance sharing industry expertise.

Expressive interactions are targeted at the sincerity-based trust and the feeling of affection, compared to instrumental interactions, which focuses on the ability-based trust and the feeling of obligation. Social expressive interactions should have greater impact on sincerity and affection, whereas instrumental interactions should have greater impact on ability and obligation.

2.3.2.3. Operating Principle: Dynamic Reciprocity

The operating principle during the building stage is *dynamic reciprocity*, which is that individuals should help those who have helped them. Dynamic reciprocity has an unequal characteristic; the return that an individual gives should be more generous than the one that the individual receives.

3. Methodology

This section presents the research method, the research design and the method discussion. In the method discussion, the reliability and validity of the study is discussed.

3.1 Research Method

This thesis adopts a qualitative research method, taking a constructivist and interpretivist viewpoint (Bryman and Bell, 2011). The aim of this study is to, by interviewing venture capitalists, understand the process of how venture capitalists initiate and build guanxi with founders. A constructivist view states that organizations and cultures are produced through social interaction processes. Moreover, an interpretivist view states that the social world is understood by interpreting it through the participants who engage in it (Bryman and Bell, 2011). This thesis adopts a constructivist and interpretivist viewpoint, since guanxi is regarded as a cultural concept created through social interaction processes and when interviewing venture capitalists, the world is understood through the people engaging in it.

In qualitative research, an inductive method, when theoretical ideas emerge out of your data, is most frequently used (Bryman and Bell, 2011). However, some qualitative researchers argue that qualitative data can and should have an important role in relation to testing of theories (Silverman, 1993). This thesis aims to test *A process model of interpersonal guanxi development*, to evaluate if and how it is applicable. Therefore, this thesis applies a deductive scientific approach (see *Figure 2. The process of deduction*). In the sixth and final step, *Revision of theory*, through a movement of induction the findings are fed back into the theory (Bryman and Bell, 2011). To take a deductive approach with an inductive approach as the last step is ideal to first test the model, and later adjust the model depending on findings.

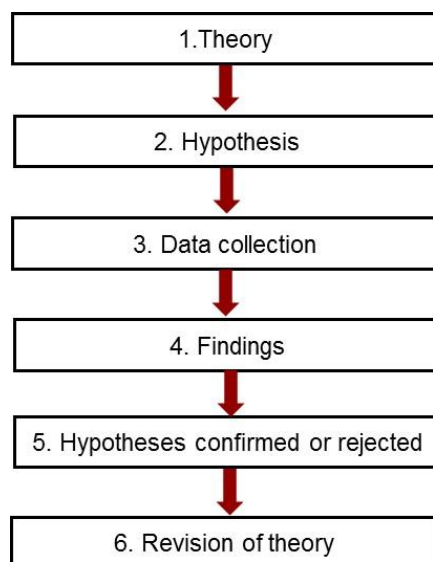


Figure 2 The process of deduction

The alternative of combining qualitative and quantitative methods had potentially been effective in trying to quantify how the venture capitalist can initiate and build guanxi with the founder. However, it was assessed that applying a quantitative method, for instance through using questionnaire with predetermined response options, would not be effective in capturing the complexity of the process of developing guanxi. Therefore, an exclusively qualitative

approach was considered preferable to understand the process in depth and not limit the respondent's views and answers through a predetermined questionnaire.

Moreover, the researchers believed that a quantitative method could be difficult to conduct in China. The respondents could be expected to open up less in a questionnaire than in face-to-face interviews, and it could be hard to gain a satisfactory number of respondents for a quantitative method since one has to first develop a relation to the interview subjects in order to get them to respond. As stated by Bruton (2003), "*In China venture capitalists prefer face to face interviews over questionnaires. It is often necessary when examining China-related business activities to establish relationships with respondents in order to receive responses*".

3.2 Research Design

3.2.1 Framework for Collection and Analysis of Data

The chosen research design is the multiple case study. This is selected since comparison can be made between the different cases, which allow the ability in assessing common and unique features within the cases. Multiple case studies are well suited for when researchers test and develop theory, which is in line with the purpose of the study. When comparing the different cases, theoretical reflections emerge which help develop findings (Bryman and Bell, 2011).

An alternative method would have been to test the model on only one venture capitalist. However, in line with Bryman and Bell (2011), generalization is considered impossible within the study of a single case. Generalization can be questioned even in a multiple case study setting, but it will in any case be significantly improved (Bryman and Bell, 2011). More on this in section 3.3 *Discussion of Method*.

3.2.2 Sample Selection

This thesis uses a snowball sampling technique, which is most commonly used in qualitative research when the goal is to sample participants in a strategic way so that those sampled are highly relevant to the research question. Snowball sampling is when an interviewee recruits future interviewees to get more respondents to the study (Bryman and Bell, 2011).

The snowball sampling technique was used since the authors found it difficult to connect with the interviewee subjects by cold emailing or calling. When examining China-related business activities, it is important to establish a relationship with respondents to receive a response. This connection can come through a referral (Ahlstrom, Bruton and Yeh, 2007). In line with Ahlstrom, Bruton and Yeh's suggestion, respondents were gained by getting introduced by a third party. For example, the authors approached the Swedish Chamber of Commerce in China, went to the Chinese Venture Capitalist event Chinapreneur¹ in Stockholm and asked all interviewee subjects to assist in introducing to potential leads. These third parties all helped getting in contact with the interviewee subjects.

¹ Chinapreneurs - A platform to connect the Swedish and Chinese entrepreneur communities.

3.2.2.1 Interviewee Subjects

The main interviewee subjects were seven different venture capitalists, from six different venture capital firms. The interviewees currently work, or have recently worked, at Western venture capital firms that operate through local offices in China, in Shanghai and/or Beijing. Three of the respondents have a Chinese origin and the remaining four respondents are from Western countries. Getting perspectives from venture capitalists with Chinese origin adds an interesting Chinese perspective on how their Western colleagues initiate and build guanxi.

The chosen interview subjects were venture capitalists from partner and associate level, since they are the actors who will be active in the due diligence process of a potential investment. The partner leads the due diligence, taking on a managing role, while the associate generally does the groundwork of gaining relevant information. Both the partner and associate will be involved in the process of developing guanxi with the startup's founders. Through interviewing both partners and associates, the researchers gained an understanding for how venture capitalists on different levels in the firm view the process of guanxi development. Five of the respondents were partners at the venture capital firms and two of them were associates.

Additionally, two other respondents were interviewed to gain a background understanding for China's institutional environment and venture capital market. One of the respondents worked with investments at Bank of China and the other respondent was a Chinese startup-founder.

For a full overview of the respondents, see *Appendix 2 - Interviews*.

3.2.3 Data Collection

When collecting data follow-up and specifying questions became central to understand how the respondents initiated and built guanxi with the founders. Thus, a semi-structured approach was appropriate which allows the interview to move in different directions and provides knowledge of what the respondents experience as relevant and important (Bryman and Bell, 2011).

An interview guide was created with the three main themes; 1. *How the connection with the founder first was initiated*. 2. *In what setting guanxi was built*. And 3. *How guanxi was built*. The questions were formulated from the interviewee's point of view and came in a chronological order based on *A process model of interpersonal guanxi development*. By asking very open questions such as "*How was the contact with the founder first established?*" The researchers took Bryman and Bell's (2011) advice in avoiding leading the respondent and adding their own values to the question.

Nine interviews were taken place in Shanghai and Beijing. Seven of the interviews were conducted face to face, at the respondent's respective offices or chosen location nearby to make it most convenient and comfortable for the interviewees. Two of the interviews were held through Skype, since the respondents were not able to meet face to face. The interviews were between 40-60 minutes in length, held in English and both authors were present during all interviews. All interviews were recorded and later transcribed for analysis.

3.2.4 Data Analysis

After the nine interviews had been conducted, the researchers assessment was that there was enough evidence to revise the proposed model. Several themes returned during all interviews, and it became clear that insights and opinions on some issues were very similar and differed on others between the interviewees. It was estimated that these patterns and contradictions provided the appropriate base for analysis.

All interviews have been transcribed in order to reduce the risk of missing important parts of the interviews that help in answering the research questions. The authors have studied the transcribed interviews separately. Themes as well as common and unique factors have been identified and sorted, and after discussed to reduce the risk of misinterpretations and misunderstandings affecting the analysis.

The analysis has aimed to test *A process model of interpersonal guanxi development*. The researchers are aware that using the model may limit the attention to new potential discoveries that do not fit into this analytical tool. However, several contradictions between the theory and the data have been identified, as well as new factors that the model does not include. Consequently, the model has been revised based on these findings and the analysis has resulted in a significant revision of the model. See 6.1 *A Process Model of the Venture Capitalist's Guanxi Development*.

3.3 Discussion of Method

Reliability is concerned with the question of whether the results of a study are repeatable. *External reliability* refers to if a study can be replicated or not and *internal reliability* is whether the researchers agree on the interpretation of data (Bryman and Bell, 2011).

External reliability is generally difficult in qualitative research, since it is impossible to freeze a social setting (LeCompte and Goetz, 1982). For instance, the meaning and importance of guanxi might change. Some researchers argue that guanxi is a result of weak regulatory institutions and transitory (see 2.2 *The Concept of Guanxi*). The internal reliability of this study can be considered high. Both researchers were present at all interviews, separate analyzes were conducted which were followed by a joint analysis to ensure consensus.

Validity is concerned with the integrity of the conclusions that are generated from a piece of research (Bryman and Bell, 2011). *External validity* is whether the results can be generalized across social settings and *internal validity* is the degree to which researchers' observations are consistent with theory (LeCompte and Goetz, 1982).

The external validity of the study is limited due to its qualitative nature. To be able to generalize the study's findings to venture capitalists in general, a greater number of interviews than the nine that have been conducted would have to be done. However, this thesis uses a multiple case study, which generally has higher external validity than a single case study (Bryman and Bell, 2011). The internal validity should be considered quite high as both authors were present during all interviews and several weeks in China were spent, thus establishing a greater understanding of Chinese society. Additionally, this thesis proposes a new model based on the papers findings, which in turn increases the internal validity.

3.4 Ethical Approach

Throughout this thesis an ethical approach has been taken by considering the four main areas presented by Diener and Crandall (1978). To avoid 1. *Lack of informed consent*, before scheduling interviews, the purpose of the study and example questions to the prospective respondent was sent. The researchers have tried to deliver as much information as needed for the prospective respondent to make an informed decision about whether to participate.

To avert 2. *Invasion of privacy*, respondents who wished were given the opportunity to approve the quotations used. Moreover, to avoid 3. *Deception* all respondents were told at the beginning of the interview that recording equipment would be used and asked if they were comfortable with it. Finally, these recordings and transcriptions have only been used in this thesis, and not in any other context, in order to not 4. *Harm the participants* (Bryman and Bell, 2011).

4. Empirical Findings

This section accounts for the empirical findings collected through semi-structured interviews with Western venture capitalists. The empirical findings lay the foundation for the analysis.

4.1 Challenges in the First Contact with the Founder

4.1.1 Language and Cultural Barriers

When meeting for the first time with the founder, all venture capitalists mention language as one barrier between the two parties and culture as another. The interviewed venture capitalists either do not speak Chinese at all or do not speak it well. Jimmie describes that not having a “cultural commonality” makes it harder to relate with each other: *“You don’t get that immediate sense of connection in the same way as you would do in the US, Sweden or Germany. It is a cultural difference, a language difference.”*

To avoid misunderstanding due to these barriers, several of the venture capitalists mention that a good method is to let local Chinese take the first meeting with the founder and thereafter introduce the parties to each other. The venture capitalists highlight that while senior management in a Western venture capital firm is from Europe or America, it is very common that the people at lower levels in majority are Chinese. These Chinese employees act as intermediates between the senior management and the local founders.

The venture capitalists experience that it is easier for a local to get Chinese founders to open up, compared to if a Westerner tries. Moreover, Harry states that it is harder for Western venture capitalists to get the founder to reveal the true story about himself:

“To get an honest picture of someone you need to understand the culture to be able to ask the right questions and thereof get the proper picture of the person. Getting the person to tell the truth is not easy if you are a foreign venture capitalist. As a foreign investor, it will never be possible to do the best deals in town due to the language and the culture barrier.”

Moreover, finding common background with the founder is easier for the locals: *“[one feels that] we are coming from the same city. If you share the same background, it’s a good way to increase trust for each other and you will have a feeling of closeness.”* (Barry).

4.1.2 Verifying If the Information Is Correct

All interviewees explain that it is hard to verify if what the founder tells is correct, due to the low transparency and reliability of information in China. For example, Jonas tells that it is hard to gain information of what companies that are registered in a specific person’s name.

When it comes to verifying information about the founder’s business, all interviewee’s point out that accounting practices are “messy” in China. Ludvig has experienced that sometimes not even the accounting firms in China will be able to verify the information received:

“If you appoint auditors to go and do a review of the company’s financial status in the West you will get a very good understanding. In China, it happens often that even the big accounting firms don’t get it right. There is so much cheating. All the financial statements, companies just fabricate them.”

Ludvig's colleague Jonas adds to his reasoning: "[...] *here you have to dig, and dig, and dig. It takes very long, even for a good auditing firm, to find out. That is a point of frustration, so then one has to find other ways to verify this.*"

4.2 How to Overcome the Challenges

4.2.1 Establishing a Network to Do Background Checks

To verify the founder's story, and gain information that is not disclosed by the founder, all venture capitalists emphasize the value of having a network that can provide a background check. The people in the network can be accountants, 'detectives', government people, lawyers, people within the startup's industry and other people in the founder's network.

The venture capitalists emphasize that they have spent a lot of time and effort building this network in China. Jimmie describes that he devoted two years building these relationships, helping the "big guys" for free: *"Now we have everything; government people, banking executives and law firms behind us. It was worth two years of working for free."*

One actor that several venture capitalists mentions as important to have in their network is a sort of 'detective' firm, that is specialized in finding out what is behind the founder. The detective firm does a lot of undercover checking up, even calling friends of the founder. The advantage of hiring the firm is that the venture capitalist does not have to ask the 'nasty' question by themselves, and risk ruining the relationship with the founder.

Many of the interviewees highlight that they contact people in their network who work in the same sector as the founder, to get their opinions about him or her. According to Ludvig, contacting people in the founder's network that you also trust and know is common: *"You take references of people: have you worked with this guy before, is he an honest guy, is he likely to cheat on you. Those kinds of things you try to acquire through your network."*

Five venture capitalists highlight that hiring local Chinese that come from the industries they invest into, who have relevant connections from their previous work and with entrepreneurs, is a way to facilitate the background check process. *"A local can have 5000 contacts on Wechat² and everyone will be from the industry. Give them a name, they can send 3 messages to people, and have a background check on any guy [founder] within 15 minutes."* (Harry).

4.2.2 Being Introduced Through Referrals

All interviewees state that they mostly are introduced to the founder through referrals. The referrals come from the venture capitalists own network or from local Chinese employees and their network. By employing Chinese who have previously worked in the sectors that the venture capitalist invests in, and gained contacts from there, relevant referrals are gained. Within the venture capitalists own network, the people giving referrals can be friends that the capitalist have in common with the founder, investors that previously invested in the founder or other people that are part of both the founder's and the venture capitalist's network.

² Wechat- China's largest Social network platform

The interviewees view the method of initiating contact with founders who they got referred to them as a way of risk mitigation. Several of the venture capitalists only approach companies referred to them by people they know. If a person in the venture capitalist's network has a relation with the founder it will mitigate the risk that they will be cheated. Ludvig states that:

"If you have common friends with the founder that you trust and know, and that also trust and know that guy [the founder], then if the founder cheats you, somehow he would lose part of his network. It is much less likely that the founder would try to fool you if you have mutual friends."

4.2.3 Skipping Part of Due Diligence Through Referrals

Jimmie, who never approaches a startup that has not been referred to him by someone in his network, tells that he uses this strategy since it otherwise is very hard to find out about the founder's real background. From his experience: *"Without going through referrals, you will not know the founders background, which in China can be quite tedious. It can be difficult to know where he or she comes from and what they have done before they come to you and want money. Therefore, going through your personal network becomes important."*

Having friends recommending founders are viewed by all venture capitalists as a way of reducing risk by eliminating the step of doing a background check, which is generally hard for Western investors. Jimmie describes that:

"We eliminate the first stage of due diligence by gaining the trust through getting the initial contact through referrals. When we need help we ask the referrals and listen to whatever they said, if they trusted it then we would trust it as well. Since guanxi is so strong in China and since I trust my network - I should not have problems."

4.2.4 With Trusted Referrals Connection Comes Immediately

Five of the venture capitalists raise the fact that they sometimes get referrals from people that they have no close relation with, for example financial advisors. The financial advisors can have some connections with the founder, but merely make the referrals as part of their job. The interviewees emphasize that when the referral comes from a financial advisor, they trust the founder much less than if the referral comes from someone that they know and trust.

When getting a referral from a person who the venture capitalist highly trusts, and who the founder also highly trusts, then the two parties will experience that they trust each other from start. *"I think the connection immediately comes through the referrals. When they are referred, we feel safe and we feel like we have a connection already. The founder usually trusts us from start, because we both trust the referral that has connected us."* (Jimmie).

4.2.5 Importance of Returning Referrals

All venture capitalists agree that returning the favor of doing referrals is very important. The favor should be of an equal or higher value than what the venture capitalist has received. *"If my friends at other funds refer a founder to me, then I would remember that, and later when I have some startups I think will fit them, I would definitely refer it to them and continuously be on the lookout for even more referrals to deliver in return."* (Barry).

The interviewees emphasize that if they get a founder referred to them, but decide not to invest, it is crucial for their own reputation within their network to keep a good contact with the founder. *"It would hurt our reputation if we treated them badly - that's why we of course, try and help them find someone else that will be more likely to invest. Guanxi is built on reputation."* (Jimmie). The venture capitalists help the founders in any way they can: *"Even if you do not do a deal in the end, you would still try to be helpful: share information that can be shared, share insights that can be shared."* (Ludvig).

However, all interviewees underline that there is a difference in treatment of referrals from people they have a close relationship with and referrals from people they do not know that well, such as a financial advisor: *"For the financial advisors, there is no return of favor but between friends there are."* (Lin). Moreover, if the referral comes from a financial advisor the venture capitalists state that they will not feel that they must help the startup in the same way as if the referral comes from a close contact. *"I would not feel obliged to treat the startup well. Because the financial advisors will get paid if they successfully refer a startup that later gets invested in. It's pure business, there is no emotional thing attached to it."* (Barry).

4.3 Getting to Know the Founder

4.3.1 Getting to Know the Founder Personally

In the beginning when venture capitalists and founders get to know each other, all interviewees describe that it is very informal and that it gets quite personal. *"It is kind of like dating when getting to know some guy or girl. You could meet them for dinner, lunch or drinks."* (Harry).

The venture capitalists state that getting to know the founder on a personal level takes multiple interactions, and becomes much more genuine if done in person than by email or social messaging apps. As stated by Harry: *"The important thing is that you meet them multiple times and that you first get to know them as a person, not just their business."* The informal social interactions range from going out for dinner or lunch, having coffee or after works. *"Beers is a very good way to lighten people up so we can get to know them. We tend to keep it in this informal way - we feel that it works better."* (Jimmie)

The venture capitalists mention that becoming friends is important in regards to mitigating risk. They acknowledge that if they are friends with the founders, the founders tend to work harder to maintain the relationship with them. Jimmie talks about that if it is "just a business relationship" the Chinese founders will not care and easier "screw you over". Further as Jimmie describes: *"[one feels that] especially in China, trust is difficult to come by. So, we tend to become friends with them and support their efforts in whatever they are trying to do, in whichever capacity that we can. Friendship is very important."*

4.3.2 Getting to Know the Founder's Business

In the beginning, it tends to be personal but as soon as they feel comfortable the venture capitalist and founder start talking business. *"When appropriate, we sit down and just grind them with questions about their business and their motivation to actually do this business."* (Jonas). When talking business, it also tends to be informal and it is important to meet the founders face to face. Four of the venture capitalists mention that they prefer to stay away from the office, because it gets to formal.

Furthermore, Ludvig, in line with numerous other venture capitalists, talks about that in general people do not discuss important business in meeting room settings. The high-level meetings will not be held in meetings rooms, instead important meetings will be held in informal settings as for instance over dinner or coffee. *“If you have an important thing - I need to tell you that we have a big problem, or a big thing that we need to do something about, it normally happens over dinner. It rarely happens in a meeting room.”* (Ludvig).

4.4 Showing Expertise as an Investor

4.4.1 Proving Expertise is Necessary

All interviewees experience that the founders will trust them from start, if the referral comes from someone whom both parties trust. However, the venture capitalist still needs to prove his or her expertise and ability. Barry explains: *“They [the founder] will feel more of a bond with us since we have a third party in common who we both trusted, but it is still very important for them to test my [the venture capitalist] ability and expertise.”*

While all interviewees believe that being referred by a common close contact affects the initial meetings with the founder, they state that the focus further on in the meetings will be on their expertise. *“It would have lots of impact for the first several meetings when getting to know the founder, but after that, when you really get down to business, then it’s your working ability or your expertise that will influence their [the founders] opinion.”* (Barry).

4.4.2 Showing Expertise in the Industry

The venture capitalists all acknowledge that showing their knowledge within the market segment and industry that the founder acts in is a great way of getting the founders to understand the venture capitalist’s ability. Furthermore, by proving their knowledge within an industry the venture capitalist and founder can share memories and feelings about different things that have happened in the market. All venture capitalists talk about the usefulness of knowing the industry and numerous venture capitalists refer to it as “just do your homework.”

“I think it is about learning their industry and situation, then you can show that you understand them. Like: I looked at your industry ten years ago, and at that time these things happened. If they feel that “oh, I was there too and I also felt that”, then they will feel that this guy understands us. That will make them [the founder] feel that I can work with this person; they understand where I am coming from.” (Harry).

4.4.3 Showing Expertise in How Chinese Business Works

Several venture capitalists highlight that it is important to show the founder that they possess the right network of people, who will be helpful in growing the founder’s startup. *“In China, it is all about your network. Here, who I know or who my friends are will be my guanxi, my powerful resource network which is key in convincing the founder, to take my money compared to other people’s money.”* (Ludvig). Barry adds that one should show that one’s network is broad: *“You need to show that you know many people in China and in different sectors- like in government, or in the sectors that the company needs contacts in.”* (Barry).

As the interviewees recognize, nobody is extremely clean in China in terms of taxes or accounting. Everyone is clean from a legal point of view, but they are all very strategic and

effective in their planning. Since it is “more clean” in the West, the interviewees experience that Chinese founders do not know how much they initially should share with the venture capitalists. Hence, the venture capitalists must show that they understand how it works in China and that they are fine with it. It is crucial that they do this since it is essential that the founder tells them the real story and not, as Barry states it, “*what their books say.*”

“If you show that you understand that strategic tax planning is how it is done here and prove that you understand that it is not a problem - then you can avoid the founders potential concern of not wanting to reveal the real information. If I tell the founders that; “Hey I understand your situation and why you’re doing it, but I need you to be honest with me.” Then they [the founders] feel, okay let’s start talking real business.” (Ludvig).

4.4.4 Showing Expertise in Western Markets

Five of the venture capitalist states that Western venture capitalists have a better reputation amongst Chinese founders compared to local Chinese venture capitalist. Western venture capitalists have experience from the Western markets where the venture capital industry is more mature and where technology and internet based companies are further developed. Harry highlights that:

“Understanding the local US market, we can make better decisions and therefore help our portfolio companies better. By understanding more mature markets we are seeing the future in a way. They [the founders] see us as someone that knows what they potentially can be in the future.”

Western venture capitalist can also help Chinese companies that want to enter Western markets. Internationally, the Western venture capitalist can help the Chinese founders find customers, capital and the right key talent. The interviewees mention that it is becoming more common for more Chinese founders to be attracted to Western venture capitalists in order to be able to extend outside of China. “*Mobike³ during their last round they specifically requested Western investors, because they wanted to extend outside China.*” (Jimmie).

³ Mobike- Famous Chinese bike transfer company

5. Analysis

In this section *A process model of interpersonal guanxi development* will be applied to the data to test if and how it is applicable on Western venture capitalists when initiating and building guanxi with founders of Chinese startups during the due diligence process.

5.1 The First Guanxi Stage: Initiating

In the *initiating stage* the guanxi objective is *setting up bases*, the interactive activity is *familiarizing* and the operating principle is *mutual self-disclosure*. The guanxi bases are *common social identities*, *common third party* and *anticipatory bases*.

5.1.1 Third Party the Most Common Base Found

When Western venture capitalists start contact with Chinese founders, it is found that being introduced to a founder by someone in the venture capitalists existing network is the most common way to initiate the relation. The common third party referrals come from people within the venture capitalists network who they have guanxi with. Hence, *common third party* is the most prominent guanxi base between the founder and the venture capitalists.

With the common third party base as the most frequently used base, the familiarization activity of finding bases between the venture capitalist and the founder will emerge naturally. This is due to that when the two parties are introduced through a third party, they know from start that they have *common third party* as a guanxi base. Hence, this base does not actively need to be found through familiarization. However, the parties have to actively try to find the other bases.

The second guanxi base, *common social identities* is often not found. This is due to the fact that for Western venture capitalists coming to China, it is uncommon to have the same birthplace, to have worked at the same local companies or to have gone to the same local schools as local Chinese founders.

The last guanxi base, *anticipatory bases*, is not found without the *common third party* base. Anticipatory bases will not be established since venture capitalists believe that going through referrals from their own guanxi network is important to reduce risk. Hence, the venture capitalists will not meet with founders without having a common third party base. However, if the venture capitalist and the founder have the common third party base, the anticipatory bases that can be found are shared future collaborations regarding the founder's business.

5.1.2 Background Check Actors to Support Familiarization

The model assumes that familiarization only happens between two actors, the venture capitalist and the founder. However, to support the familiarization activity this thesis suggests to add the concept of *background check actors*.

The *background check actors* are the people that verify the information given by the founder regarding his or her own background and the startup's background, as well as adding information that has not been disclosed by the founder. Relevant background check actors to involve are accountants, legal experts, previous colleagues of the founder, employees from detective firms and any other contacts who can verify and give information.

Within the *initiating stage*, the operating principle is *mutual self-disclosure*. The venture capitalists experience that in Chinese culture, there is a low level of self-disclosure towards people that one does not have a close relationship with. Therefore, it can be difficult for the founders to open up. Furthermore, in the venture capital industry in China the familiarization process is extra difficult due to two major problems; 1. The founder discloses information that is not correct, and 2. The founder withholds important information. The *background check actors* therefore need to be added to the model to verify the information disclosed as well as provide information that is not disclosed. Hence, the actors support the familiarization activity of finding guanxi bases through verifying and disclosing different guanxi bases.

5.1.3 Establishing a Guanxi Network

Since the venture capitalists rely on third party referrals, building a quality guanxi network in China becomes very important. The thesis finds that successful Western venture capitalists have either: 1. Spent years building their own network before starting to invest or 2. Hired local Chinese.

Local Chinese have been hired due to three factors: 1. They can provide third party referrals, either by themselves or through their network, 2. They have a greater local network of background check actors and 3. They are more likely to find common social identities with the startup founders.

Firstly, since they have the preferred networks they can be the third party referrals. When venture capitalists have hired local Chinese, they have matched the industries they want to invest in with the industries that the local Chinese previously have worked in. Hence, the local Chinese will have all the contacts that the venture capitalist wants.

Secondly, local Chinese are hired because they have a greater local network of actors that can provide background checks. And thirdly, local Chinese are more likely to find common social identities with the Chinese founder. Having common social identities is a guanxi base from which guanxi can be built. Additionally, due to cultural barriers it is easier for the Chinese founder to open up to a local employee, increasing the founder's level of self-disclosure.

5.2 The Second Guanxi Stage: Building

In the *building stage*, the guanxi objective is *enhancing quality*, the interactive activities are *expressive and instrumental interactions* and the operating principle is *dynamic reciprocity*. The guanxi quality is determined by *trust*, which is composed of *ability* and *sincerity*, and *feeling*, which in turn is composed of *affection* and *obligation*.

5.2.1 Trust

5.2.1.1 Sincerity Arises Through Third Party Referral

Sincerity, which is the first factor that leads to trust, refers to when an individual has the other parts best interest at heart. The venture capitalists' experiences that the relationship with the founder automatically feels more sincere and trustworthy when introduced to the founder by a third party. Therefore, when venture capitalists are introduced to founders through a common third party the sincerity factor will automatically arise.

The sincerity factor will naturally arise because the third party that introduces the venture capitalist to the founder, has quality *guanxi* with both parties and as theory states, this will mean that the third party will have both of their best interests in mind.

Since the third party has both parties best interest in mind, the referral would never happen if the third party did not believe that it was in favor of both the venture capitalist and the founder to establish a relationship. Consequently, the founder can assume that the venture capitalist will have its best interest in mind, because otherwise the third party would not have introduced the two parties to each other. Therefore, the venture capitalist does not actively have to demonstrate that it has the founder's best interest in mind.

5.2.1.2 Ability is Built Through Instrumental Interactions

Ability, the second factor that leads to trust, refers to an individual's competence or expertise in specific domain areas. Ability can be proven through *instrumental interactions*, which refer to transactions and exchanges related to business.

Examples of instrumental interactions that Western venture capitalists show is that they demonstrate their expertise in bringing startups overseas and show that they have experience within other more mature venture capital markets. Furthermore, they have a dialogue that shows that they have an understanding for the chosen industry and they convince the founders that they have a relevant *guanxi* network for their business.

Ability, compared to sincerity, does not naturally arise through a referral. A founder can get multiple quality *guanxi* referrals which ensure that the relationship is sincere, but ability needs to be shown by the venture capitalist to be understood by the founder.

5.2.2 Feeling

5.2.2.1 Affection is Built Through Expressive Interactions

Affection, the first factor that leads to feeling, refers to the degree of emotional understanding and connection. Affection is built through *expressive interactions*, which are social-oriented activities.

The venture capitalists highlight that due to cultural and language barriers, it is often hard for them to feel an immediate sense of connection and emotional understanding with the Chinese founders. Hence, the first step in building the relation with the founder is to meet them in informal settings, with the aim of getting to know them on a personal level, understanding their motivations and personality. Furthermore, in this step it is important for the Western venture capitalist to show that they have an understanding of how doing business in China works. For example, showing that they understand and accept effective tax planning and accounting tricks. Since this is frowned upon in the West, this is an important barrier to break through for a Western venture capitalist in order to be able to connect and create emotional understanding with the Chinese founder.

Examples of expressive interactions that Western venture capitalists do to create affection with founders are having dinners together, taking them out for beers or having coffee. The venture capitalists tend to avoid the office because of the formality it brings, and only do face-to-face meetings; never email or text messaging apps. Venture capitalists believe that

meetings in informal settings are the most effective way to create a sense of connection with the founders. Even the most important meetings are held in very informal settings, since from experience, that makes the founders open up the most. The venture capitalists emphasize that gaining connection with the founder is a very long process; they refer to it as “kind of like dating” in getting to know someone, which requires multiple meetings over time.

5.2.2.2 Obligation Arises Through Third Party Referral

Obligation, the second factor that leads to feeling, refers to the indebtedness that results from social and economic transactions. Obligation is often described in terms of amount and depth due to a long exchange history or a wide scope of exchanges.

As described by the venture capitalists it is important for them to, after getting a referral, follow up on the referral in order to uphold a quality *guanxi* with the third party introducer. Following up on the referral does not always mean that the venture capitalist will invest. However, it does mean that they will give the founder an honest chance and if they do not invest, they will instead help the founder find another suitable investor or help them in other ways. As stated by the venture capitalists it is important to always leave on a good note with every referral. This is important in order to ensure that the venture capitalists own reputation stays intact and to honor the quality *guanxi* with the third party introducer.

Important to note is that the obligation to follow up on the referral and start building a relationship arises between the venture capitalist and the common third party introducer. Through this, an obligation between the venture capitalist and the founder indirectly arises.

Affection, in contrast to obligation, cannot evolve through a referral. Affection needs to be experienced between the venture capitalist and the founder to be developed.

5.2.3 Dynamic Reciprocity Spurs Referrals

The operating principle during the building stage is *dynamic reciprocity*. The general principle is that individuals should help those who have helped them. Furthermore, the return that an individual gives should be more generous than the one that the individual receives.

When the venture capitalist receives a favor in terms of a referral from a third party, he or she will, due to the importance of returning favors in China, feel committed to return the favor. The favor will be returned to the third party with another referral, and if possible a referral of higher value. As explained by all venture capitalists, returning favors is important in Chinese culture and therefore the referral process will be a never-ending circle of referrals between parties with high quality *guanxi*. This supports *common third party* being the dominant base when venture capitalists and founders familiarize in the initiating stage.

Since venture capitalists only familiarize with founders they have a *common third party* base with, receiving referrals is vital for *guanxi* to be initiated with the founder. Consequently, if the venture capitalists have and cherish a quality *guanxi* network, that gives them referrals, they will be more likely to build *guanxi* with the founders.

In the tested model the authors propose that there is dynamic reciprocity between the two tested actors, in this thesis case, the venture capitalist and the founder. However, our data

finds that the dynamic reciprocity occurs between one of the tested actors, the venture capitalist and another third party actor, the third party referrals.

5.3 Clarification of Third Party Referrals

The venture capitalists get founders referred to them from two types of contacts. Firstly, it is from people that both the venture capitalist and the founder have a guanxi with. Secondly, it is from people that both parties do not know very well, and therefore do not have guanxi with. Examples of people venture capitalists get referrals from, but who they do not have a guanxi with, are financial advisors.

Referrals from financial advisors, or other people whom the venture capitalist and founders do not have a guanxi with, will not be part of the adjusted model presented (see 6.1 *A Process Model of the Venture Capitalists Guanxi Development*). Financial advisors will not be part of the model because they do not fit into the criteria to be a common third party base. Chen and Chen state that the guanxi base *common third party* refers to when two individuals are acquainted through a third party who they both have guanxi with. The venture capitalist and the founder do not both have guanxi with financial advisors.

6. Discussion and Conclusions

This section presents a revised version of *A process model of interpersonal guanxi development*. Furthermore, the implications and relevance of the results are discussed.

6.1 A Process Model of the Venture Capitalist's Guanxi Development

The explored thesis question is:

“How do Western venture capitalists initiate and build guanxi with founders of Chinese startups during the due diligence process?”

In response to the research question, the thesis finds that parts of *A process model of interpersonal guanxi development* is applicable. However, based on analysis of the data a revised model, *A process model of the venture capitalist's guanxi development*, is developed and presented below. The model, as illustrated in Figure 3, identifies the most important factors when initiating and building guanxi between Western venture capitalists and Chinese founders in China.

A process model of the venture capitalist's guanxi development

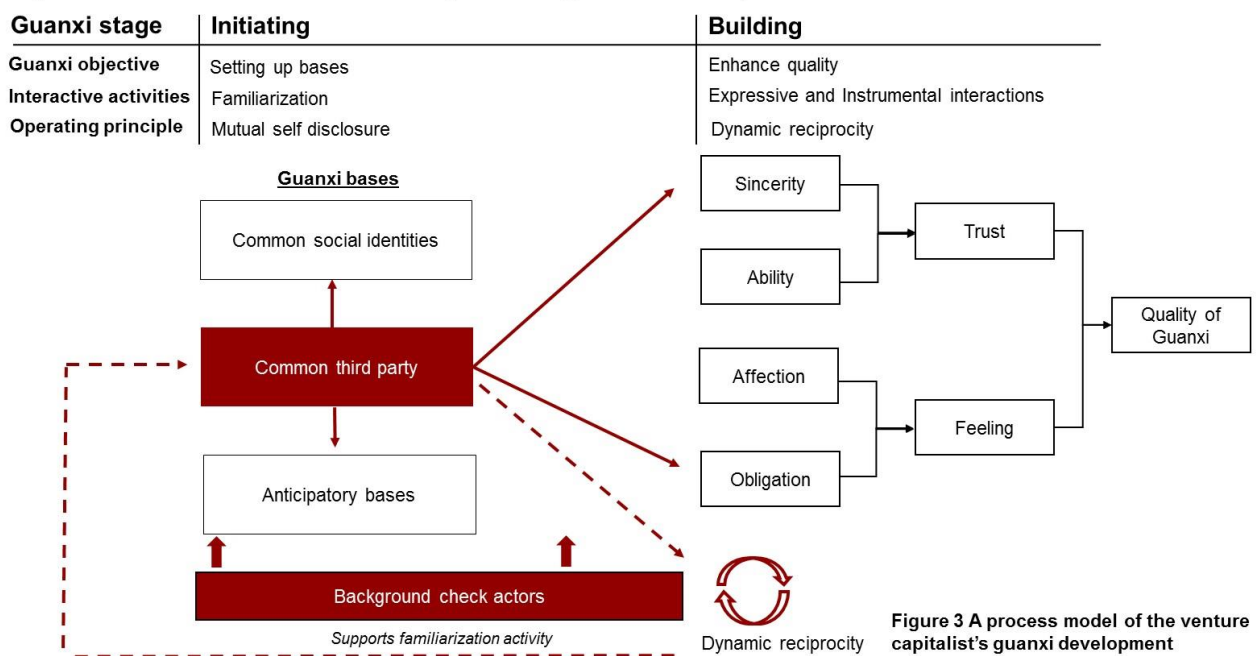


Figure 3 A process model of the venture capitalist's guanxi development

In the *initiating* stage, the guanxi objective is setting up bases and the most frequently used base is *common third party*. Hence, in Figure 3 common third party is highlighted with a bright red color. With the common third party as the most frequently used base, familiarization will emerge naturally between the founder and the venture capitalist. This is since the common third party base will not have to be actively found through familiarization; the parties will know from start that they share one guanxi base when they are introduced through referral from a third party. Regarding the two other bases, common social identities are most often not found and anticipatory bases can only be revealed if the two parties have a common third party.

Background check actors are added since the operating principle *mutual self-disclosure* is problematic. It is problematic since the founder has a low level of self-disclosure and because the information disclosed can be inaccurate since the transparency and reliability of information in China is low. The founder's low level of self-disclosure is since in Chinese culture people do not share information with anyone they do not have an established relationship with. Therefore, the *background check actors* support the *familiarization* activity by verifying the information disclosed as well as providing relevant information that is not disclosed. These actors will help disclose and verify the different *guanxi* bases.

The building stages *guanxi* objective is *enhancing quality*, which is determined by *trust* and *feeling*. Trust is composed of *sincerity* and *ability*, and feeling is composed of *affection* and *obligation*. By familiarizing through a common third party in the initiating stage, *sincerity* and *obligation* will automatically arise. This is shown in Figure 3 with the red arrows pointing from common third party to sincerity and obligation. *Ability* will be proven by the venture capitalists to the founders by the interactive activities *instrumental interactions*, and *affection* will be shown by the interactive activities *expressive interactions*.

The operating principle *dynamic reciprocity*, which is that individuals should help those who have helped them, will be expressed in this model through the venture capitalists will to follow up on the common third party's referral. Due to the fact that returning favors is important in Chinese culture, the referral process will be a never-ending circle of referrals between parties with high quality *guanxi*. Important to note is that the dynamic reciprocity in *A process model of the venture capitalist's development* occurs between the venture capitalist and the common third party.

This thesis contributes to the research on how individuals at one firm build personal connections with people at other firms to enhance firm performance, known as *guanxi strategies*. From a management perspective, this thesis concludes that an effective *guanxi* strategy for Western venture capitalists is to establish a *guanxi* network to receive referrals from. Building a *guanxi* network to receive referrals can either be done from scratch, which takes time, or through the shortcut of hiring Chinese employees. These locals possess the relevant networks through previously working in the sectors the venture capitalist invests in.

By going through referrals, the *common third party* base is gained. This is an efficient strategy to develop *guanxi*, since then the two factors leading to quality *guanxi* will arise automatically. Consequently, the venture capitalists can devote their time and resources on demonstrating the two remaining factors for the founder: *ability* and *affection*.

To conclude, this thesis finds that Western venture capitalist's *guanxi* on a *network level* strongly facilitates their development of *guanxi* with a Chinese founder on an *interpersonal level*. Consequently, having and cherishing a quality *guanxi* network that enables referrals is a recommended strategy to effectively initiate and build *guanxi* with Chinese founders.

6.2 Contribution of Study

This thesis has tested Chen and Chen's *A process model of interpersonal guanxi development* on Western venture capitalists and Chinese startup founders. To apply to the venture capital setting in China, the adjusted model *A process model of the venture capitalist's guanxi development* is proposed. As Chen and Chen's model has not previously been empirically tested, this thesis contributes to the research on guanxi development.

Moreover, this thesis adds to the guanxi research within the field of venture capital, by studying *how* guanxi is developed with founders of a startup of interest during the due diligence process. Previous research within venture capital has only focused on the *value* of having guanxi with the founder in order to receive information in the due diligence.

Since the Chinese venture capital is booming, Western venture capitalists interest for entering the Chinese market will likely continue to grow. For investors, it will be important to understand how to initiate and build guanxi with founders of Chinese startups. Hence, this study provides valuable insights for future investors that are considering entering China.

6.3 Generalizability

It is acknowledged that the study is based on relatively few interviews, which can make generalization hard. The study's generalizability is based upon that the premise that the respondents have provided a representative view of Western venture capitalists in China is correct. That venture capitalists on both partner level and associate level were studied has presumably enhanced their representative ability.

Furthermore, since guanxi is an indigenous Chinese concept that is part of the Chinese culture the findings cannot be generalized outside the context of China. The aim has not been to generalize the guanxi development process beyond the setting of China.

6.4 Suggestions for Further Research

Further research could test if this thesis proposed model, *A process model of the venture capitalist's guanxi development*, holds on a larger sample of venture capitalists in China.

Additionally, this thesis has only studied the process of guanxi development through the lens of the venture capitalist. Future research could examine how the founders experience the venture capitalists' efforts of developing guanxi with them, to evaluate if the proposed model holds through the view of the founders. Moreover, the guanxi development process has only been studied through looking at the actions of the venture capitalist. One suggestion for future research is to study the actions taken by the founders to build guanxi; for instance, how they show their ability and affection to gain the *venture capitalists* trust and feeling.

In addition, this thesis has only tested the first two steps, the *initiating stage* and the *building stage* of Chen and Chen's model. Future studies could examine the third stage, the *using stage*, when one operates a high quality guanxi relation. This type of study could test if the assumption made in this thesis, that the benefit for Western venture capitalist in the last stage is receiving more information from the founder during the due diligence, holds.

Finally, future research could test if this thesis proposed model applies for non-Chinese venture capitalists other than Western venture capitalists.

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Appendix 2 - Interviews

Name	Firm	Title	Date and place
	<u>Venture capital firm</u>		
Carrie Wang	KKR Capstone (Ex, left 2015)	Associate	April 10, 2017. <i>Skype</i>
Barry Yan	Origo Partners (Ex, left 2013)	Associate	April 13, 2017. <i>Beijing, café nearby office</i>
Harry Man	Matrix Partners China	Partner	April 11, 2017. <i>Beijing, at office</i>
Jimmie Jeremejev	Matias Patrick Capital	Partner	April 10, 2017. <i>Beijing, café nearby office</i>
Jonas Alsén	Jade Invest	Partner	April 5, 2017. <i>Shanghai, at office</i>
Ludvig Nilsson	Jade Invest	Partner	April 5, 2017. <i>Shanghai, at office</i>
Peter Rosta	Foundation Asia Pacific	Partner	April 12, 2017. <i>Beijing, café</i>
	<u>Other</u>		
Tianlin Shao	Bank of China (the investment branch)	Associate	April 12, 2017. <i>Skype</i>
Brian Starry	Starry Media, (Chinese Startup)	Founder	March 30, 2017. <i>Shanghai, café</i>

Table 2 Interviews