



## Turning water into wine? Exploring the role of dynamic capabilities in early-stage capitalization processes



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### ARTICLE INFO

#### Article history:

Received 15 August 2012

Received in revised form 8 July 2014

Accepted 15 July 2014

Available online 30 July 2014

Field Editor: J.J. Chrisman

#### Keywords:

Resource-based theory

Early-stage capital

Technology-based ventures

Dynamic managerial capabilities

Entrepreneurial teams

### ABSTRACT

Technology-based ventures face considerable challenges when attempting to raise early-stage capital during the early-stages of development. To create an operational business they need access to financial capital, but external investors prefer to see an operational business before investing capital. This study extends arguments grounded in dynamic managerial capabilities theory to examine the extent to which various trade-offs among the quality of a venture's management team, radicalness of the firm's technological resources, and demand uncertainty in focal markets impact the ability of ventures to resolve these capitalization challenges. We find that higher levels of demand uncertainty and more radical innovations do not appear to enhance the impact of strong management teams on the raising of early-stage capital. However, lower levels of uncertainty do appear to strengthen the effects of strong management teams. Implications of these findings for dynamic capabilities theory and early-stage capitalization processes are discussed.

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### 1. Executive summary

High quality management teams are thought to be critically important to early-stage ventures in overcoming the challenges of commercializing radically innovative technologies and navigating the waters of change in turbulent industries. Consistent with this view, investors often claim that they would rather “invest in an ‘A’ management team with a ‘B’ technology, than a ‘B’ management team with an ‘A’ technology”. In contrast, other commentators argue that even the most competent teams will often not be able to overcome the uncertainty inherent in startup environments. Instead, investors – especially early-stage investors – tend to favor some predictability in their investments and do not prefer taking extraordinary risks.

This study examines these competing views and explores how the capabilities of the management team impact the investment of early-stage capital into technology ventures under varying conditions of uncertainty. More specifically, we explore how various configurations of management teams, markets, and technologies impact the raising of early-stage capital for new ventures. To explore these questions, we assembled a database of 123 seed-to-early-stage technology-based ventures that were started between July 1, 1999 and December 31, 2007. Since, in most cases, the firms enter our sample before even formally incorporating, our sample overcomes survivorship bias – one of the most difficult issues in entrepreneurship research.

Consistent with these questions, our analyses indicate that the higher quality management teams increase the likelihood that technology ventures will raise early-stage capital. However, when these strong management teams are linked with radical

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innovations and higher demand uncertainty of the external markets, the value of quality management teams increases only marginally. By implication, these results indicate that while early-stage investors do value high quality management teams, the predominant explanations for *why* investors might favor these teams are weakly supported by our analyses. In light of these findings, we offer several implications for emerging theory on the role and impact of dynamic managerial capabilities in entrepreneurial ventures.

Second, our study offers several important implications for practice. While the quality of the management team matters, other factors such as the market context and technological resources of the firm can dampen the impact of the management team. As such, especially for more technologically oriented founders who anticipate the need to raise outside funding, the conventional wisdom to hire an experienced management team at this stage may be pre-mature. Instead, when raising capital in the context of higher levels of technological and demand uncertainty, founders should focus on resolving the uncertainties inherent with the technology and/or market.

Finally, our results suggest that early-stage investors may benefit from using a real options investment strategy and investing smaller tranches of capital in ventures beset by high levels of uncertainty, regardless of the quality of the management team. We base this recommendation on the fact that it appears that investing in high quality management teams is limited by the fact that "...even the most competent team cannot turn water into wine" (Bhidé, 2008: 46). Therefore, convincing early-stage ventures to hire outside management with excellent experience and/or credentials as the conventional view suggests may encumber these ventures with excess labor costs that are not actually critical to the current stage of development.

## 2. Introduction

Early-stage technology-based ventures face significant challenges when attempting to raise external capital to fund the early phases of development: to create an operational business they need access to financial capital, but external investors generally prefer to see an operational business before investing capital (Bowers, 2008; Gompers et al., 2010). To resolve these challenges, new ventures compete in early-stage capital markets on the basis of three factors: the capabilities of the management team, the attributes of the technology, and the characteristics of the market in which the firm will operate (Bhidé, 2008). Naturally, firms operating in large, high-growth markets with star management teams and transformational technologies are likely to be more successful in competing for early-stage capital (Bhidé, 2008). However, early-stage ventures rarely exhibit all three ideal characteristics. Instead, these ventures operate in dynamic environments where "changes in industry structure, (in) stability of market demand, and probability of environmental shocks," (Sirmon et al., 2007: 275) coupled with unproven, radically-new technologies create substantial uncertainty thereby forcing investors to make significant trade-offs (Kaplan and Strömberg, 2004; Kaplan et al., 2009). Although early-stage investors are typically willing to accept some risk in one or two of these dimensions (for example, uncertain technology in high growth markets) scant evidence exists that investors are willing to accept risk in all three dimensions (MacMillan et al., 1985). As a result, a central agenda of entrepreneurial finance research is to explore how various configurations of these factors affect key capitalization outcomes for early-stage ventures (Kaplan and Strömberg, 2004; Kaplan et al., 2009).

The capabilities of the founding management team play a central role in attracting early-stage capital investments (Kaplan and Strömberg, 2004; MacMillan et al., 1985; Shane and Stuart, 2002). Consistent with this view, prominent investors such as Georges Doriot, one of the founders of the U.S. venture capital industry, often claim that they would rather "invest in an 'A' management team with a 'B' technology, than a 'B' management team with an 'A' technology" (Zacharakis and Meyer, 1998). According to resource-based logic, this preference exists due to the ability of high quality management teams to attract and utilize invested resources efficiently/effectively from key stakeholders (Erikson, 2002; Holcomb et al., 2009; Packalen, 2007), to improve the innovativeness of product offerings (Marvel and Lumpkin, 2007), and to increase firm growth/survival rates directly (Bates, 1990; Cooper et al., 1994; Gimeno et al., 1997). In short, high quality management teams are thought to be critically important to early-stage ventures, enabling the firm to overcome the challenges inherent in commercializing radically-innovative, new technologies, adapting ventures to the demand uncertainty inherent in dynamic markets (Kaplan and Strömberg, 2004; Zingales, 2000), and creating new opportunities (Alvarez and Barney, 2007).

Recent work in the finance literature challenges this view and argues that the contextualization of technological resources in markets through the venture's business idea plays a more central role in attracting capital to the firm in the early-stage capitalization processes than the quality of the management team (Kaplan et al., 2009). This perspective argues that the functional value of founding management teams is far more limited since "...even the most competent team cannot turn water into wine" (Bhidé, 2008: 46). Fundamentally, this research argues that early-stage investors may be over-weighting the importance of the capabilities of the management team (Baum and Silverman, 2004).

To address this critical view of management teams, this study builds on the dynamic managerial capabilities literature to explore how various configurations of management teams, markets, and technologies impact key early-stage capitalization outcomes for 123 technology-based ventures. Our analyses indicate that the substantive capabilities of the management team (Zahra et al., 2006) appear to increase the likelihood of technology ventures to raise early-stage capital. However, when these managerial capabilities are linked with radical innovations and demand uncertainty in external markets, the resulting resource-oriented and market-oriented dynamic capabilities (Barreto, 2010) do not appear to enhance capitalization outcomes for technology ventures. For emerging theory on dynamic capabilities, these results confirm prior speculation that dynamic capabilities do not always positively enhance firm performance outcomes (Zahra et al., 2006). In addition, these results suggest that many early-stage ventures do not possess well-formed resource- or market-oriented dynamic capabilities to convince early-stage investors to supply significant amounts of capital. Instead, these ventures potentially often operate with higher levels of capital constraints. Overall, these results suggest

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