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How much prestige is enough? Assessing the value of multiple types of high-status affiliates for young firms[☆]

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ABSTRACT

Young, unproven firms can signal their worthiness, or potential, through affiliations with various types of prestigious parties. Drawing from signaling theory, we present a formal consideration of the implications of multiple numbers and types of prestigious affiliates for IPO valuations. We argue that different types of prestigious affiliates – prestigious executives, directors, venture capital firms, and underwriters – convey different signals of IPO worth, depending on the extent to which they provide certification or substantive benefits. Based on a sample of 257 software IPOs, we find considerable support for our expectations. The benefits of prestigious executives and directors accumulate in a linear, more is better fashion; in contrast, the payoffs from VC and underwriter prestige accumulate in a curvilinear fashion. We discuss the theoretical implications of these findings and propose an agenda for future research.

1. Executive summary

We elaborate on the distinction between the certification and substantive benefits of prestigious affiliates, presenting a comprehensive analysis of the implications of multiple numbers and types of prestigious affiliates for IPO valuations. Although scholars have acknowledged that prestigious affiliates vary in the nature of the resources they bring to bear on an IPO firm's behalf (e.g., Jain and Kini, 2000; Sahlman, 1990; Wasserman, 2003), they have largely conflated the certification and substantive benefits of different types of affiliates. Further, while some scholars have considered the simultaneous effects of more than one type of prestigious affiliate on IPO outcomes, they have examined the influence of multiple parties in a purely *ceteris paribus* fashion (e.g., Gulati and Higgins, 2003; Sanders and Boivie, 2004; Stuart et al., 1999). Little attention has been paid to the relationships *among* the different signals, and how the certification and substantive value of each type of signal influences investors' interpretations as they assign value to the newly public firm.

Our study advances understanding of this socially and economically important phenomenon by drawing a theoretical distinction between the certification and substantive benefits prestigious affiliates can bring to an IPO. In particular, we explore the extent to

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which multiple prestigious affiliates of a given type are seen by investors as additively valuable, as opposed to merely corroborative or even redundant. While prior research has considered the effects of one prestigious underwriter or one VC on IPO valuations, our study is the first to examine the influence of the *number* of prestigious underwriters, VCs, executives and directors. Second, we consider the extent to which the presence of *multiple types* of prestigious affiliates are additive versus redundant in the signals they provide.

Our sample included 257 U.S. IPOs between 1994 and 1996 in three sectors of the computer software industry. Consistent with our hypotheses, our results suggest that every additional prestigious executive and director tends to bring additive value; this value does not diminish as the number of prestigious actors accumulates, and it is only minimally reduced by the presence of other types of prestigious affiliates. Thus, prestigious executives and directors clearly exhibit linear effects on IPO valuations, in a “more is better” pattern. Our results also support our hypotheses that multiple prestigious VCs and underwriters are somewhat redundant in the signals they provide. Although the addition of each prestigious VC and underwriter brings some additional value in the eyes of investors, the marginal benefit diminishes with each additional prestigious affiliate. Further, our results suggest that prestigious underwriters only partially mediate the effects of other forms of prestige.

In sum, our results suggest two potentially important theoretical implications. First, our analysis reveals that the benefits of having multiple prestigious affiliates vary depending on the type of affiliate. Second, our study suggests that prestigious affiliates differ in the extent to which they provide information about the past as opposed to the future. For example, our findings regarding the linear effects of prestigious executives and directors are consistent with expectations that these actors will be more involved in the ongoing operations of the company and will be with the company for a time following the IPO. Thus, the information provided by their presence is prospective. In contrast, the effects of prestigious venture capitalists – who may have provided the firm with a variety of resources during its development, but who are expected to largely sever their ties with the company shortly after its IPO – accumulate in a plateauing, curvilinear fashion. Thus, the information that prestigious VCs signal is more retrospective in nature. Prestigious underwriters, who play an important role at the time of the IPO and in creating the conditions for immediate success thereafter, have a stronger effect than VCs on IPO valuations, but the relationship is still curvilinear. The information they provide is somewhat prospective, but short-term in nature.

2. Introduction

Scholars have long been interested in the effects of interorganizational relationships on a focal organization's behaviors and performance (e.g., Baum et al., 2000; Pfeffer and Salancik, 1978). External linkages can occur through board seats, prior employment affiliations, officerships in trade associations, alliances, and other means. They affect a firm's access to information (Geletkanycz and Hambrick, 1997), ideas (Davis and Greve, 1997), social capital (Fischer and Pollock, 2004; Miner et al., 1990) and other resources (D'Aveni, 1990).

Recently, scholars have become particularly interested in the effects of prestigious affiliates, or relationships with entities that are prominent and socially central, on the market valuations of initial public offerings (IPOs) (e.g., Gulati and Higgins, 2003; Pollock et al., 2004; Stuart et al., 1999). Researchers have been drawn to IPOs as an arena where prestigious affiliates might matter greatly, because these companies typically have limited track records and resources and otherwise carry considerable uncertainty. Under this line of thought, investors will value a newly-public firm more highly if it has prestigious affiliates that convey assurances of quality. By examining the initial valuations of IPOs – or the value of the company's shares at the end of the first day of trading – scholars are able to gauge investors' expectations about the firm's prospects. Thus, the broad question that prior researchers have posed about prestigious affiliates in the IPO context is this: How does the presence of prestigious affiliates affect investors' assessments of the prospects of the firm (Carter and Manaster, 1990; Gulati and Higgins, 2003; Stuart et al., 1999)?

However, the literature on the value of prestigious affiliates has stopped short of providing two important clarifications, both of which are essential for theory to advance and practical insights to be generated. First, there has been little effort to theoretically distinguish between the different types of benefits prestigious affiliates can provide. Generally, researchers emphasize that prestigious affiliates serve an “endorsement” function, certifying the quality of the IPO firm (e.g., Carter and Manaster, 1990; Lee and Wahal, 2004; Sanders and Boivie, 2004; Stuart et al., 1999). Some scholars also have argued that prestigious parties may provide substantive resources, such as abundant social and human capital, that can help to improve the actual functioning of the IPO firm (e.g., Bygrave and Timmons, 1992; Fischer and Pollock, 2004; Jain and Kini, 2000). We might reasonably expect that different types of prestigious affiliates confer different mixes of these two benefits. For instance, prestigious executives might bring substantive benefits based on their experience, capabilities and connections which can be of on-going benefit to a company; by comparison, prestigious underwriters may primarily serve a certification function, aiding a firm in capitalizing on the resources it has accumulated. Both types of affiliates would enhance the value of the IPO in the eyes of investors, but for different reasons; and these differences could greatly affect the optimal mix and amounts of prestigious affiliates for impressing investors.

The lack of theoretical distinction between the certification and substantive benefits of prestigious affiliates makes the second void in the literature all the more notable. Specifically, there has been relatively little attention paid to the implications of having *multiple* prestigious affiliates – either of a given type or of different types. IPO firms can potentially attract various types and quantities of prestigious affiliates, including executives with blue-chip credentials, outside directors with lustrous backgrounds, prominent venture capital firms (VCs), and top-tier underwriters. What is not clear from prior research is the extent to which multiple prestigious affiliates operate in an additive and/or substitutive manner in affecting investors' valuations.

Incorporating the distinction between certification and substantive benefits helps us understand – and predict – the effects of multiple numbers and types of prestigious affiliates on IPO valuations. If a given type of prestigious affiliate provides primarily substantive benefits, every additional affiliate of this type should add to the value of the firm on a generally linear basis; moreover,