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Funding decisions and entrepreneurial team diversity: A field study

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ABSTRACT

This study provides experimental evidence, using a large sample of 2894 individuals recruited via business media websites, about the impact of demographic attributes within entrepreneurial teams on funding decisions by external capital providers. In previous work the role of diversity with regard to personal characteristics within entrepreneurial teams, such as education, gender and nationality was not clear. Specifically, we focus on task-oriented (e.g., education, experience) and relations-oriented (e.g., age, nationality) dimensions of diversity. The participants of our experiment had to decide on providing early-stage funding to a team of start-up managers whereas the diversity of these teams varied across treatment groups. We find that task-oriented diversity is positively and significantly related to the willingness of respondents to provide capital. Interestingly, the same applies for relations-oriented diversity. This suggests social capital of an entrepreneurial team matters to a greater extent to funding decisions of external investors than the behavioral integration of the team's human capital. Entrepreneurial teams must therefore carefully balance the social costs of non-task-related diversity and the access to financial resources.

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1. Introduction

Decision-makers are often forced to act in situations characterized by high risk, time constraints and lack of information. Business plans or crowdfunding websites provide only limited information on the strategy and resources of a new venture,

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and in most cases, investors consider this information incompletely. Previous work indicates that investors build their decisions on their evaluations of the founders of the new business to a significant extent (e.g., Goslin and Barge, 1986; MacMillan and SubbaNarasimha, 1987).

In this paper we provide new insights about how particular dimensions of team diversity affect investors' decisions to provide seed money to a founding team of entrepreneurs. In an online field experiment with 2894 readers of German business media we investigate whether task-oriented (i.e., educational background, educational level and leadership experience) and relations-oriented diversity (i.e., age and nationality) have an impact on the funding decision. Our experimental setting allows us to study actual decision-making in well-defined situations. The results from our large-scale experiment indicate that task-oriented diversity in an entrepreneurial team is positively and significantly related to the willingness of respondents to invest venture capital. Interestingly, the same applies also to relations-oriented diversity. The latter, somewhat surprising, finding suggests that providers of VC regard the social capital of an entrepreneurial team, with relation to the access it affords to critical resources, as more important than the behavioral integration of its human capital.

Our paper has two main contributions. First, we provide novel in-depth insights about the impact of demographic variety, educational background, gender and ethnical diversity. Previous research on the link between the demographic variety of venturing teams and investment decisions by VC providers has so far considered this topic from a rather vague perspective. In particular, evidence about demographic characteristics that are not related to the tasks of a venturing team, such as age, gender and nationality, is scarce (e.g., Hall and Hofer, 1993; Petty and Gruber, 2011). Second, we contribute evidence from a large scale experiment that provides direct observations of the decision-making process itself, where most of the previous work relies on post hoc investigation—most commonly on self-reports in surveys. However, VC providers might be unaware of the criteria on which they base their decisions and therefore give erroneous accounts of the number and weighting of these criteria (e.g., Sandberg et al., 1988; Shepherd and Zacharakis, 1999).

Besides contributing to the academic literature on venture funding and decision-making, our study has also managerial implications for capital providers, as well as for entrepreneurs. Providers of VC may amend their decision heuristics, and thus improve the quality of their decisions, if they are aware of the criteria they actually use when they evaluate applications. Shedding light on the determining criteria in this process may help to prevent idiosyncratic behavior when it comes to decision-making, and thus improve the efficiency of resource allocation. Conversely, would-be company founders can improve their chances of securing investment capital if they have a better understanding of how providers of VC reach their decisions. This helps capital-seeking entrepreneurs to meet the criteria that investors apply in their evaluations more effectively. Moreover, since financing difficulties are the main reason for the failure of business start-up projects, improved access to capital can raise the newly founded company's chances of success.

The remainder of the paper is organized as follows: in the next section, we briefly review previous research on the extent and manner in which investors take into account entrepreneurial teams in general and demographic diversity more specifically when making investment decisions. Leveraging the literature on team effectiveness, we develop five hypotheses on the impact of entrepreneurial team diversity on the willingness of decision-makers to invest in a business. In Section 3 we introduce the data and methods of our study and in Section 4 we present our estimation approach and our results. In the final section, we discuss the theoretical and practical implications of these findings, outline some of the limitations of our study and draw our conclusions.

2. Literature review and hypotheses

Our hypotheses build on an extensive body of literature that tackles the question of whether the demography of an entrepreneurial team may be regarded as a signal of the venture's future performance. Signaling theory (Spence, 1974) affirms that it may. The cognitive legitimacy of a new business, and thus the ability to gain venture capital, increase when the founders conform to the expectations of investors with regard to the demographic features that effective teams should possess (Higgins and Gulati, 2006; Packalen, 2007). According to these arguments and related evidence (e.g., Shepherd, 1999b), investors can be expected to base their decisions on certain attributes of the entrepreneurial team, which are considered to predict the actual and potential effectiveness of the entrepreneurial team in terms of the new venture's success.

Two lines of reasoning emerge from the existing literature on the impact of team composition on the performance of a new venture. The first perspective is consistent with "similarity/attraction theories" (Cantner et al., 2011). According to that view, demographic similarity facilitates frequent and rich interaction among the team members; in return, this is positively related to unity as well as continuity of purpose (Amason et al., 2006). Members of homogeneous teams find it easier to interact with one another because communication barriers arising from demographic dissimilarities are lower than in heterogeneous teams. Effective communication among team members translates into task-related consensus on missions, strategies and objectives. Agreement on the purpose of a new venture accelerates decision-making and enables team members to focus on their job. Moreover, by fostering the creation and sharing of tacit knowledge, communication enhances a team's ability to learn quickly. Adaptability through learning is a crucial driver of team performance because new ventures operate under high uncertainty and risk in dynamic environments. This line of reasoning suggests that, the less diverse the composition of venturing teams in demographic terms, the better they perform. In that respect, from the perspective of similarity/attraction theories, homogeneous teams are more likely to attract financial resources than heterogeneous teams.

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