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## Skills or networks? Success and fundraising determinants in a low performing venture capital market

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### ABSTRACT

This paper provides a novel interpretation of the factors leading to low performance in venture capital (VC) markets. By using human and social capital perspectives, we investigate the relationship between the professional experience and education of VC firm managers and i) the success of their portfolio firms on one hand and ii) their fundraising activity on the other. Our study focuses on the French VC market. The French business environment is characterized by tight links between businesses and the state and by powerful elite networks, while the VC industry has been dominated by government funding and incentives since the global financial crisis. We evidence a positive relationship between task-specific human capital variables and the exit success of VC-backed firms. However, unlike the research from the US market, we find no support for the claim that success determinants impact fundraising activity. Instead, we substantiate the importance of higher social networks for raising larger funds in markets with strong networks.

### 1. Introduction

It is acknowledged that in the United States it was a vibrant and efficient venture capital (VC) industry that had been at the origin of the country's innovation boom, economic growth and competitiveness in the 1980s and henceforth (Gompers, 1994). In an attempt to replicate the US success, many European countries have put in place different initiatives aimed at boosting their respective VC markets. Yet, after more than two decades of efforts, the US VC industry is still envied for its performance. Lower human capital was put forward as one of key determinants of the lower performance of European VC firms, impairing both firm selection (Wright et al., 2006) and value adding behavior (Sapienza et al., 1996).

Although human capital is central to the entrepreneurship literature, it is not widely researched in a VC context. Hellmann (2000) purports that the performance of VC firms is highly dependent on their teams and their ability to select portfolio firms, add value or arrange exits in optimal manner. The few scholars that have examined the performance of VC-backed firms through a human capital lens did so in the context of portfolio exits (Bottazzi et al., 2008; Dimov and Shepherd, 2005; Zarutskie, 2010). The relationship between the human capital of VC managers and the performance of their portfolio firms represents an important and underresearched question and we lack knowledge whether human capital determinants impact in the same way the two principal exit channels, trade sales and IPOs. Moreover, VC managers also develop social capital. At the organizational level, VC

firms can develop ties with other investment firms which can represent an important source of funding for their portfolios (Alexy et al., 2012; Hochberg et al., 2007). VC professionals usually come to VC firms from other organizations, where they fostered tight bonds with their colleagues (Tirole, 1986). They often bring along a solid stakeholder network including investors, industry experts, suppliers, customers and/or potential acquirers, which can all be beneficial to the development of portfolio firms (Knockaert et al., 2006; Pratch, 2005). To our knowledge, many of these personal dimensions of social capital have not been researched in the context of VC performance.

As regards VC fundraising activity, human and social capital studies are scarce. For example, Zarutskie (2010) found that the human capital characteristics which determine a VC fund's success also tend to drive the fundraising activity of the follow-on funds. This is in line with Kaplan and Schoar's work (2005) which evidences performance as a facilitator to the raising of both follow-on and larger funds.

These results seem intuitively evident: when a fund manager performs well, stakeholders are likely to trust him or her again and with more money. And these findings are indeed recurrent in all studies that examine the US market, which has a significant positive performance history. But what about poor performing markets? The French VC market is an interesting comparative field because it differs in many ways from the US market. Firstly, it persistently records disappointing results: in the past decade the French VC industry has reported a positive Internal Rate of Return (IRR) only once, in 2007 (Source: AFIC). Secondly, deleveraging of the financial system after the 2008 financial

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crisis and regulatory changes unfavorable to the VC industry (Basel III and Solvency II) have pushed traditional investors, such as banks and insurance companies, away from the VC industry. To fill this gap, the government has constantly increased its intervention, so much so that public funding and tax-subsidized investments from private individuals have become the dominant VC investments in France.<sup>1</sup> Thirdly, the French business environment stands out from the US and most developed economies due to its tight relations with the State. Most of the higher corporate executives obtain their positions thanks to their career in the public sector (Maclean et al., 2007). And finally, the French corporate and public sector elite almost without exception comes from a small number of highly selective higher education institutions, which are well known for their powerful networks (Maclean et al., 2006). Grounded in this evidence, we endeavor to throw light on the role of human and social capital for both performance and fundraising activity in such a radically different market. Research from countries characterized by weak institutions shows that entrepreneurs with significant government connections are more likely to benefit from the public support programs, which in turn has a positive impact on entrepreneurial development and performance (Charoensukmongkol, 2016; Stel and Naudé, 2015). However, legal and financial institutions in France are strong and VC investments concern principally high-technology and innovative ventures. We know little which role, if any, public and educational networks play for entrepreneurial development and which for fundraising.

This paper makes several contributions. First, we show how in a poor performing VC market, such as France, VC performance and fundraising are disconnected due to important social networks which facilitate fundraising for low performing VC firms. Secondly, we contribute to the body of research on human and social capital theory in relation to VC performance. We extend previous analysis on human capital by showing how two important task-specific human capital characteristics that were not previously researched, namely experience in research and development and in investment banking, relate to VC performance. We also show that these two types of experience predict better trade sales than IPOs, while entrepreneurial experience is associated with higher probability of an IPO. We show that public and education networks of VC managers do not facilitate successful exits, suggesting that neither public experience nor education in elitist institutions contribute to the acquisition of superior selection and value-adding skills. Finally, we show that the allocation of government and tax-subsidized funds is not driven by performance, but rather by organizational and personal networks of VC firms and their managers. We thus add to the literature on social networks in a finance and business context, evidencing how powerful professional networks can facilitate fundraising and thereby contribute to important distortions in the VC market, rendering it inefficient.

## 2. Theory and hypotheses

### 2.1. Human capital and VC industry

Human capital comprises skills and knowledge gained through formal education and professional experience (Becker, 1964). The importance of skills for entrepreneurial development and growth has been amply documented in the entrepreneurial literature. Human capital was found to be critical for many firm development factors such as opportunity recognition (Gruber et al., 2012; Marvel, 2011), radical innovativeness (Marvel and Lumpkin, 2007), patenting behavior (Allen et al., 2007), firm legitimacy (Packalen, 2007) and access to external financial resources (Beckman et al., 2007). Founders' human capital was also found to be a determining success factor when exploiting risky

opportunities (Dencker and Gruber, 2013). While early research studies focused on individual human capital (Cooper et al., 1994), recent studies suggest the importance of the human capital characteristics of entire teams for firm success (Amason et al., 2006; Gruber et al., 2012).

In the financial intermediation literature, funds have been found to exhibit significant performance persistence over time (Brown and Goetzmann, 1995). This suggests that the performance of VC firms is strongly dependent on the human capital of their teams. Besides financial resources, venture capitalists provide a set of services to entrepreneurial ventures, and these can thus be seen as resources added to the firms they invest in (Pfeffer and Salancik, 1978). Just as for entrepreneurial ventures, VC firms' human capital also impacts upon the success of their portfolio firms. Better and higher human quality of VC investment members induces better decision making at all stages of the VC investment cycle, from portfolio firm selection, through value-adding activities, until the portfolio firms' exit (Dimov and Shepherd, 2005). Indeed, the previous experience of VC firm managers is found to be an important determinant of their industry investment choice (Knockaert et al., 2010) and the level of involvement in developing their portfolio companies (Knockaert et al., 2006). Several studies empirically test the relationship between the human capital of VC firms' managers and the performance of their portfolio firms. Bottazzi et al. (2008) explored the role of business and venture experience, and found the former to be a major determinant of value adding activism and performance. A more nuanced analysis provided by Dimov and Shepherd (2005) and Zarutskie (2010) included experience in start-ups, finance, consulting and law, but offered somewhat contrasting results. In this vein, we draw on the literature on task-specific human capital (Gibbons and Waldman, 2004) to offer a more refined analysis of different types of experience, especially in science, entrepreneurship and finance and how they relate to different performance outcomes and fundraising activity.

### 2.2. Social capital, performance and favoritism

Social networks represent nodes of people and/or organizations, tied to each other on the basis of their social relationships or interests, and can be a key factor for individuals and organizations to reach their goals (Wasserman and Faust, 1995). Social ties are essential to entrepreneurial development: relationships enable entrepreneurs to attract VC funding (Beckman et al., 2007) and benefit from higher valuations (Hsu, 2004), and are found, overall, to be a core determinant of the long-term performance of entrepreneurial ventures (Shane and Stuart, 2002).

As regards the VC firms themselves, their managers build networks on the basis of their contacts with many different stakeholders. For one, they develop relationships with other VCs by syndicating their deals, which can help them share risk and information (Bygrave, 1988) and get access to "better" deals, i.e. invest in entrepreneurial ventures with higher growth perspectives (Kaplan and Schoar, 2005). Next, they often have significant industrial and financial contacts which can be of particular benefit for the development of their portfolio firms. These include contacts with investors, customers, suppliers and/or candidates for their portfolio firms' top management teams. Finally, their relationships with potential financial or corporate acquirers facilitates portfolio exit (Sapienza et al., 1996). Research has found different beneficial impacts of social capital on investment choices and the performance of VC-backed firms. VCs with larger and broader syndication networks are found to manage both geographically and industrially diversified portfolios (Sorenson and Stuart, 2001). Syndication relationships were also found to be a good predictor of funding, survival and exits of VC portfolio companies (Alexy et al., 2012; Hochberg et al., 2007). Finally, better networked VC firms get financially better deals: in order to be backed by renowned VCs and benefit from their higher quality networks, entrepreneurs agree to cede a part of their equity, i.e. accept lower valuations (Hsu, 2004).

<sup>1</sup> According to data published by EVCA (2014), government agencies and tax-subsidized investment schemes contributed to more than two thirds of funds raised in 2013.

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