Journal of Economics and Business 65 (2013) 55–85

Contents lists available at SciVerse ScienceDirect

Journal of Economics and Business

Private firm investors and product market relationships: Certification and networking

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A R T I C L E I N F O

Article history:
Received 27 May 2011
Received in revised form 3 October 2012
Accepted 6 October 2012

JEL classification:
G24
G30

Keywords:
Venture capital
Angel investors
Strategic alliance
Product market relationships

A B S T R A C T

In this paper, we examine how private firm investors facilitate value-enhancing product market relationships by either certifying firm value to potential partners or through their industry networks. Employing novel methods to distinguish these two effects, we find that firms backed by venture capital and angel investors are significantly more likely to form value-enhancing product market relationships and these relationships will be with more prominent counterparties. Furthermore, we find a significant difference between services provided by venture capital versus by angel investors. Venture capital investors provide benefits from certification and industry networking while angel investors only provide benefits from networking, but provide no detectable certification benefits.

1. Introduction

Active shareholders such as venture capitalists bring a variety of valuable skills to the entrepreneurial firm. The prior literature has investigated activities such as obtaining future rounds of financing (Gorman & Sahlman, 1989), facilitating changes in the top management (Hellman & Puri, 2002), helping the firm find new investors at the time of the IPO (Chemmanur, Krishnan, & Loutskina, 2011), improving firm operating performance (Chemmanur, Nandy, & Krishnan, 2012), and providing valuable product market benefits to the firm. Several studies report empirical evidence that these product market benefits may occur via different mechanisms. For instance, Hellman and Puri (2000)

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0148-6195/$ – see front matter
http://dx.doi.org/10.1016/j.jeconbus.2012.10.001

show that venture capital backing is associated with accelerated product introductions to the marketplace while Chemmanur, Loutskina, and Tian (2011) show that corporate venture capitalists can increase the innovativeness of firms. Venture investors may also provide value through enhancing firm relationships with customers (Maula, Autio, & Murray, 2005). However, despite the importance of the relationships between firms and outside parties such as customers and strategic alliance partners, there has been considerably less evidence examining how private firm investors facilitate these important relationships with other parties leading up to an initial public offering.

In this paper, we examine the association of two important types of investors in private firms, venture capital and angel investors, with two kinds of firm relationships: strategic alliances and large customer relationships. We focus in particular on strategic alliances and large customers because both strategic alliances (Stuart, Hoang, & Hybels, 1999) and large customer relationships (Johnson, Kang, & Yi, 2010) have significant consequences on a firm's operating performance, investment policies, and firm value. As mentioned by Chemmanur (2010), active shareholders play a vital role enhancing firm value ". . . by helping [firms] develop . . . contacts and credibility with suppliers and customers . . ."[1] We are interested in the two important mechanisms mentioned specifically by Chemmanur (2010): developing contacts (networking) and enhancing firm credibility (certification). For this purpose, we study a unique set of firms, private firms in the process of going through an initial public offering (IPO). The fact that these firms are going public allows us to access important disclosures required by the Securities Exchange Commission (SEC) concerning the investors in the firm. But since these firms are not yet public, we observe the equity structure and the presence of important strategic alliances and customer relationships in private (pre-IPO) firms. This allows us unique insight into the equity financing of small private firms. We find that in a sample of 636 IPO firms from 2001 to 2007, 51% have venture capital investors, 13% have angel investors,[2] and 2% have family investors.[3] We combine this pre-IPO investor information with details about firm relationships with large customers and strategic alliance partners at the time of the IPO gleaned from the COMPUSTAT segment level disclosure data, the IPO prospectus, and firm annual reports.

We begin by examining the prevalence of strategic alliances and large customer relationships in our sample of firms. We find that firms backed by venture capitalists or backed by angel investors are more likely to disclose strategic alliances and large customer relationships, even after controlling for industry and firm characteristics. We also find that the prominence of the alliance partners and large customers are higher for venture capital backed firms.

Concerning the role of pre-IPO investors in facilitating an IPO firm's product market relationships with alliance partners and large customers, we propose two non-exclusive hypotheses. Our first hypothesis is the Certification hypothesis which states that firms are better able to enter important value-enhancing relationships when they have pre-IPO investors such as venture capital and angel investors since these investors act as certifying informational intermediaries in the sense of Leland and Pyle (1977) and Megginson and Weiss (1991). The previous literature including Almazan, Suarez, and Titman (2009) suggests that information asymmetry may impede in the formation of valuable product market relationships.

We call our second hypothesis the Networking hypothesis which states that pre-IPO investors create a network of value-creating parties which the IPO firm can more easily access because of its relationship with the venture capital or angel investor. Venture capital and angel investors may facilitate valuable relationships with customers, alliance partners, or other important stakeholders because they provide links to other firms and potential trading partners (Lindsey, 2008).

[1] We define an active shareholder as any shareholder who takes a direct role in the operations, management, financing, governance, or strategic activities of the firm.

[2] We use the term angel investor and private investor interchangeably in this paper. Angel investors refer to any individual making an investment of their own capital on their own behalf. See Appendix A for a more detailed discussion of the definition of an angel investor. We also classify firms with family investors separately from angel investors (see Appendix B). Our results are not appreciably different if we classify the family investors as angel investors.

[3] These categories are not mutually exclusive. In our sample of firms, 8% of the IPOs have angel and venture backing, 6% have only angel backing, and 42% have only venture backing.