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Journal of Business Venturing 20 (2005) 1–21

JOURNAL of BUSINESS VENTURING

Human capital theory and venture capital firms: exploring "home runs" and "strike outs"

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Received 1 November 2002; received in revised form 1 October 2003; accepted 1 December 2003

Abstract

Using a human capital perspective, we investigated the relationship between the education and experience of the top management teams of venture capital firms (VCFs) and the firms' performance. We found that although general human capital had a positive association with the proportion of portfolio companies that went public [initial public offering (IPO)], specific human capital did not. However, we did find that specific human capital was negatively associated with the proportion of portfolio companies that went bankrupt. Interestingly, some findings were contrary to expectations from a human capital perspective, specifically the relationship between general human capital and the proportion of portfolio companies that went bankrupt. Future research is suggested.

Keywords: Venture capital firms; Human capital; Initial public offering; Bankruptcy

1. Executive summary

Venture capitalists (VCs) who can better assess and assist portfolio companies will have more successful exits from their portfolio companies and fewer portfolio companies that provide no return to the venture capital firm (VCF). Human capital theory posits that individuals with more or higher quality human capital achieve higher performance in

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0883-9026/$ – see front matter
doi:10.1016/j.jbusvent.2003.12.007

executing relevant tasks such as the pre- and post-investment activities of the venture capital process. In this article, we investigate the relationship between human capital and the performance of VCFs. Specifically, we explore the types of education and industry experiences represented by the top management teams of VCFs, and then investigate their relationship with two dimensions of investment performance: ‘‘home runs’’ (portfolio companies that go public) and ‘‘strike outs’’ (portfolio companies that go bankrupt).

While there were no significant results for specific human capital in explaining home runs, there were expected results for specific human capital in explaining strike outs and for general human capital in explaining home runs. Specifically, our findings suggest that aspects of general human capital—education in science and humanities—have a positive association with the proportion of home runs in a VCF's portfolio. The results for strike outs show that VCFs with top management teams with higher specific human capital—MBA, law education, and consulting experience—have lower proportions of bankruptcies in their portfolios. Surprisingly, we also found that law industry experience was positively associated with the proportion of bankruptcies in a VCF's portfolio. Another set of surprising findings concerned the relationship between general human capital and strike outs: VCFs with higher prevalence of science and humanities education among their top management team members had higher prevalence of bankruptcies in their portfolios.

This article makes a number of contributions. First, we use a more fine-grained approach to human capital by investigating the performance effects of different types of education and experience represented by a VCF's top management team. Second, we acknowledge two dimensions of performance and investigate how types of human capital are differentially associated with these performance dimensions. Third, the venture capital and entrepreneurship literatures have focused on understanding home runs [initial public offerings (IPO)], but have relatively ignored the potential downside of performance outcomes. We add to this literature an investigation of portfolio company bankruptcies. Finally, we offer a number of important topics for future research.

In addition, the results of this study have some important implications for practitioners. VCFs may build their investment teams with a human capital consideration in mind. Understanding the human capital factors contributing to achieving more home runs and less strike outs can help build teams that increase firm performance. But they must acknowledge that aspects of human capital differ in their impact on each performance dimension. Similarly, entrepreneurs seeking venture capital finance may increase their awareness of the value that a VCF could bring to their start-up company. By pre-examining the backgrounds of the VCFs' top management teams, entrepreneurs can target those VCFs that could make the greatest contribution to their success.

2. Introduction

The belief that the decisions of top management teams impact firm outcomes is central to the literatures of strategy and management. Strategists who can accurately predict and adapt to changes in the external environment can better position their companies for success.