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Ethnic matching in the U.S. venture capital market☆

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ABSTRACT

We document the role of entrepreneurial founder and venture capital (VC) partner co-ethnicity in shaping investment relationships. Co-ethnicity increases the likelihood that a VC firm invests in a company. Conditional on investment, co-ethnicity strengthens the degree of involvement by raising the likelihood of VC board of director involvement and increasing the size and scope of investment. These results are consistent with trust and social-network based mechanisms. Shared ethnicity in our sample is associated with worse investment outcomes as measured by investment liquidity, however, which our results suggest might stem from looser screening and/or corporate governance.

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1. Executive summary

In addition to being resource-poor like other entrepreneurs, ethnic entrepreneurs face a further challenge of financial resource assembly by virtue of their ethnic status. While most of the existing literature studies remedies involving the rise of informal institutions (such as rotating credit associations) or changes to formal ones (such as changes to legal or regulatory rules affecting banks), we explore how co-ethnicity between venture capitalists (VCs) and entrepreneurs can accomplish a similar financing function. In the context of the U.S. VC industry, we find that such co-ethnicity is correlated with a higher likelihood of investment, and that co-ethnic investments take place earlier and with much deeper resource commitments on the part of the VC. However, investment matches based on shared ethnicity are correlated with less successful company outcomes.

This research opens the possibility that social proximity and networks can, within existing formal financial institutions, overcome the challenge of funding ethnic entrepreneurs. Kinship and behavioral preference-based motivations, as well as faster and more complete information transmission stemming from a shared social network, are dual mechanisms behind the tightly-coupled co-ethnic economic relations. The results also identify possible trade-offs associated with this phenomenon of ethnic investment matching.

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2. Introduction

Entrepreneurs who are ethnic minority immigrants form a large subgroup of all innovation-based founders in the United States (Saxenian, 1999, 2006; Wadhwa et al., 2007). For companies launched between 1995 and 2005, there was at least one key immigrant founder in 25% of technology and engineering companies across the U.S., and in 52% of all companies based in Silicon Valley. A sizeable fraction of venture capital (VC) firms also employs ethnic minority professionals. Individuals with a shared ethnicity often form networks where they interact and exchange ideas with each other. As reported by Saxenian (2006), there are at least 30 professional and networking associations targeting immigrants in Silicon Valley alone (e.g., The Indus Entrepreneur, TiE), composing over 33,000 members. Therefore, ethnic ties could be an important factor in shaping how the U.S. VC market operates. We empirically examine this expectation, and show that a shared ethnicity (between investment partners and founders) matters for whether, when and how VC firms invest in companies.

Ethnic businesses may face special organizational resource-acquisition challenges stemming from their disadvantaged ethnic business status beyond the already significant obstacles facing the typical new enterprise (for an overview, please see Aldrich and Waldinger, 1990), though there is heterogeneity in the degree to which ethnic groups face such resource challenges (e.g., Bates, 1994, 1997). This is due to immigrant entrepreneurs' often circumscribed access to established financial institutions such as banks and credit.

This funding access shortfall for ethnic entrepreneurs has motivated the vast majority of literature related to both discrimination and the rise of informal institutions to address the funding gap. Studies of markets for small business credit suggest statistical discrimination toward racial minorities (e.g., Cavalluzzo and Cavalluzzo, 1998; Blanchflower et al., 2003). The well-documented phenomenon of ethnically-based rotating credit associations (e.g., Geertz, 1962) is a good example of an informal social-network based institution arising to address ethnic business shortfalls in financial resource mobilization.

Our research departs from examining how informal institutions or even reforms to formal institutions (for example, through legal or regulatory action) can address financial access by ethnic entrepreneurs. Our empirical findings suggest that having co-ethnics on both sides of a formal resource market, the market for venture capital finance, can accomplish a similar function with regard to shaping the likelihood of investment matches and the depth of such relationships when investments are made.

From a broader perspective, our findings add to the literature on the impact of culture in economic exchange (Becker, 1996; Guiso et al., 2006; Iyer and Schoar, 2010). That literature defines culture as shared values, beliefs, and norms of a group or community (a definition that fits well with ethnic groups). In the same vein, our evidence contributes to the growing literature showing that *social* proximity, in addition to geographical proximity, can matter for financial relationships.[1] This perspective complements the literature showing the importance of ethnicity for trust (Glaeser et al., 2000; Fisman, 2003), innovation (Agrawal et al., 2007; Kerr, 2008) and founding team composition (Ruef et al., 2003).

An open issue under this form of ethnic-network-based resource access is the *extent* to which this network structure can provide resources to the entrepreneurial venture. A broader understanding of the depth of economic relationships conditional on a match (which in turn is significantly related to interpersonal affiliation as proxied by co-ethnicity) is important, and is the most novel aspect of our analyses. The intensity of such co-ethnic relationships may suggest implications about the process of resource acquisition for less advantaged entrepreneurs, who also may not have the same access to formal resources as others. For example, our results help us understand the *depth* of investment relationship embeddedness between co-ethnics as compared to non co-ethnics along the dimensions of board representation and the span of involvement, all else equal.

There is also an interesting timing-of-resource-acquisition dimension to our analyses, which contributes to a better understanding of the evolution and persistence of homophily in certain economic relationships and markets. For example, one side of a market may get seeded as a result of accident or purpose with certain types of individuals. Our evidence suggests a process, at least in the VC context, by which there is reinforcement of those characteristics in the market quite early on in the relationship for co-ethnics (board representation and first round of funding participation). While beyond the scope of our paper, the finding that co-ethnic networks for resource flows are activated early in an investment relationship rather than evolving in strength only later has implications for social and public policy. Note that this inference would not be possible under the existing analyses in the literature predicting the likelihood of an investment relationship.

By analyzing a large dataset covering a broad cross-section of the U.S. VC industry, we find that a shared ethnicity between founder and VC increases the probability of an investment match from 4.7 to 5.7 percentage points, a 21% increase. Furthermore, conditional on an investment, co-ethnicity of the counterparties is associated with much deeper investments as measured by the likelihood of board-level involvement (a 16 percentage point increase), earlier and more persistent investment behavior (the probability of a first round investment is raised by 10 percentage points), more capital invested ($3 million more, on average), and more entrepreneur-friendly financial contracts.[2] A caveat to these results is that we measure ethnicity coarsely, via surnames of individuals, but this measurement allows us to study a much larger sample. We later discuss the benefits and costs to this approach.

[1] Most existing papers study social proximity based on a shared university affiliation. One set of findings suggests that a shared university affiliation can be beneficial by helping mutual fund managers outperform the market (Cohen et al., 2008) and financial analysts make better forecasts (Cohen et al., 2010). Another set of findings, however, suggests that social ties based on university affiliation can be detrimental: it can worsen corporate governance (Nguyen, 2012) and is associated with lower market valuations (Fracassi and Tate, 2012). A final set of findings show that social ties based on university affiliation can make firms behave in more similar ways, such as with respect to executive compensation (Shue, 2013).

[2] These statistics are calculated from univariate comparisons. Regression results with controls yield similar magnitudes. Furthermore, the results are robust to a variety of controls, including VC firm and company fixed effects. Our regressions with company fixed effects compares the investment behaviors of the focal VC firm versus other VC firms investing in the focal company; our regressions with VC firm fixed effects compares the focal VC firm's investment behavior in the focal company compared to other companies. Because the coefficient on founder-VC co-ethnicity remains qualitatively similar across specifications with different included fixed effects, we rule out the possibility of time invariant omitted variables driving the results.

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