



Upper echelons and portfolio strategies of venture capital firms

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ABSTRACT

In this study we analyze how the composition of the top management team (TMT) influences the portfolio strategy choice in venture capital (VC) organizations. We develop a model of risk perception to investigate how education and experience of TMT members impact whether VC organizations invest with a focus on early stage ventures or not, specialize or diversify across industries, and invest with a broad or narrow geographic scope.

Evaluation of data on TMTs and portfolio strategies of 136 European VC firms revealed that VC firms with higher proportions of TMT members with science/engineering education and entrepreneurial experience more likely invest with an early stage focus. Furthermore, TMTs with more management education diversify their portfolios more across industries. Finally, the more international experience TMT members of VC organizations have, the broader the geographic scope of investees. We discuss the implications of our findings for the VC literature.

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1. Executive summary

Investment decisions of venture capitalists (VCs) have long been of interest in the entrepreneurship literature, and scholars have advanced our understanding of how the characteristics of new ventures, the venture founding team, industry structure, the VC managers' background, and their cognitive biases influence the decision policies of VC managers. While the judgements of individual VC managers are important for the decisions of VC organizations to invest in a particular venture or not, upper echelon theory suggests that strategic decisions at the organizational level such as the choice of the VC organization's portfolio strategy are drawn by entire top management teams (TMTs) rather than individual VC managers.

In this study we analyze whether the composition of TMTs explains variance in the portfolio strategies of VC organizations. We develop a model of risk perception to investigate how education and experience of the TMT members impact whether VC organizations invest with a focus on early stage ventures or not, specialize or diversify across industries, and invest with a broad or narrow geographic scope.

Evaluation of data on TMTs and portfolio strategies of 136 European VC firms revealed that VC firms with higher proportions of TMT members with science/engineering education and entrepreneurial experience more likely invest with an early stage focus. Furthermore, TMTs with more management education diversify their portfolios more across industries. Finally, the more international experience TMT members of VC organizations have, the broader the geographic scope of investees.

Our study advances the literature on VC decision making in various ways. First, research linking VC manager characteristics with investment decisions has focused on the level of individual VC managers, but neglected the TMT. Our study focuses on the TMT and demonstrates that the composition of the VC organizations' management team explains variance in portfolio strategies. Second, scholars analyzing the investment criteria of VC firms have emphasized the characteristics of new ventures, the venture founding team, and industry structure, but little is known about strategic decisions at the organizational level. Our study uses

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portfolio strategy choice as a dependent variable. Finally, we answer a recent call for more upper echelon research concentrating on the type rather than the amount of education and experience as factors explaining the strategic decisions of TMTs.

Two practical implications arise from our study. First, venture capitalists can better understand how education and experience present within their TMTs impact their collective decision policies with respect to preference of investment stages, industry diversity, and geographic scope. Second, entrepreneurs will find different types of expertise in VC firms depending on the portfolio strategy of the firm and should thus consider this strategy when seeking venture capital funding.

2. Introduction

Investment decisions of venture capitalists (VCs) have long been of interest in the entrepreneurship literature. For example, scholars have analyzed how the characteristics of new ventures, the venture founding team, and industry structure influence the VC managers' decision policies (MacMillan and Narasimha, 1987; Muzyka et al., 1996; Shepherd, 1999a; Tyebjee and Bruno, 1984). Moreover, research has investigated the impact of the VC managers' background (Dimov et al., 2007; Franke et al., 2006) and trust in the venture founding team (Harrison et al., 1997; Shepherd and Zacharakis, 2001) on these decisions. Another body of literature has shown that decisions of VC managers are complex and subject to a variety of cognitive biases (Franke et al., 2006; Shepherd, 1999b; Zacharakis and Meyer, 1998; Zacharakis and Shepherd, 2001).

While all these studies have made important contributions to advance our understanding of how VC firms select their investees, most of them have focused on decision policies of individual VC managers. For example, researchers have used field experiments to study the selection criteria of VC managers (Shepherd, 1999a), the impact of VC managers' experiences (Franke et al., 2006; Shepherd et al., 2003), and the decision biases of individual VC managers (Zacharakis and Meyer, 1998; Zacharakis and Shepherd, 2001). However, it is known that in organizations many important decisions are drawn by the top management team (TMT), and that the composition of the team influences decision outcomes (Carpenter et al., 2004; Hambrick and Mason, 1984). Thus, recently VC researchers have started to take a team perspective and argued that the composition of the TMT influences organizational outcomes of VC firms. Consistent with Dimov et al. (2007), we define TMTs in the context of the VC industry as all individuals with the highest ranking titles within the VC firms.

In their first study on TMTs in VC firms, Dimov and Shepherd (2005) argued that perceptions of risk, return, opportunities, and threats are central to the decision making of TMTs in VC firms and therefore determine, in part, the performance of the VC organization. Their data support this view by demonstrating that VC organizations with TMTs with higher levels of general and specific human capital have fewer of their portfolio ventures going bankrupt. In a follow-on study, Dimov et al. (2007) argued that TMTs with more financial expertise have more knowledge and abilities to manage financial risks, specifically those risks that are represented by later stage investees. In line with this assumption, they found that VC organizations invest more in mature ventures when higher proportions of their TMT members have financial expertise. A systematic and broader investigation of the impact of TMT characteristics on the VC firms' strategic choices, however, is missing in the literature.

One central strategic decision of TMTs in VC firms is the choice of their portfolio strategy (Dimov et al., 2007). For example, VC firms can either focus their portfolios on early stage ventures or also include late stage investees (Elango et al., 1995; Manigart et al., 2002). Moreover, some VC firms focus their investments on one or a few industries, whereas others diversify their portfolios across different sectors (Gupta and Sapienza, 1992; Norton and Tenenbaum, 1993). Research has also shown that some VC firms select their investees within a small geographic region while others invest internationally or even globally (Gupta and Sapienza, 1992; Hall and Tu, 2003). In this study, we analyze whether the composition of TMTs can explain variance in portfolio strategy choice. We develop a model of risk perception of TMTs in VC firms and argue that this risk perception depends on the education and experiences of TMT members (Carpenter et al., 2004; Corter and Chen, 2006; Finkelstein and Hambrick, 1996; Hambrick and Mason, 1984). We test our hypotheses with data on 136 European VC firms.

Our article makes the following contributions. First, research linking VC manager characteristics with investment decisions has focused on the level of individual VC managers (Franke et al., 2006; Zacharakis and Shepherd, 2001), but neglected the TMT. Our study focuses on the team level and demonstrates that the composition of the VC firms' TMTs explains variance in portfolio strategies. Second, scholars analyzing the investment criteria of VC firms have emphasized the characteristics of new ventures, the venture founding team, and the venture's industry structure (MacMillan and Narasimha, 1987; Muzyka et al., 1996; Shepherd, 1999a; Tyebjee and Bruno, 1984), but little is known about organizational-level strategic decisions of VC firms. Our study uses the organizational-level portfolio strategy choice as a dependent variable. Finally, we answer a recent call for more upper echelon research concentrating on the type rather than the amount of education and experience as factors explaining the strategic decisions of TMTs (Dimov et al., 2007).

In the following section we will develop our hypotheses before we describe our data and methodology. We will then introduce our results, followed by a discussion and conclusions.

3. Theory and hypotheses

Upper echelon theory suggests that the composition of the TMT influences organizational-level strategies. The cognitive models of TMT members determine how managers perceive their task environment, and these perceptions mediate the effect of the objective environment on strategic choice (Bateman and Zeithaml, 1989; Carpenter et al., 2004; Finkelstein and Hambrick, 1996; Hambrick and Mason, 1984). The perceptions of the TMT depend, in part, on the observable demographic characteristics, particularly the educations and experiences, of the team members (Carpenter et al., 2004; Hambrick and Mason, 1984). For

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