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Fostering Dynamic Growth in New Ventures through Venture Capital: Conceptualizing Venture Capital Capabilities

Olimpia Meglio, Arabella Mocciaro Li Destri, Arturo Capasso

There is ample evidence of the influence of venture capital on the creation and growth of new ventures, yet scant attention has been paid to the heterogeneity of venture capitalists and their capacity to contribute to the dynamic growth of new ventures. This paper aims to contribute to the existing literature by exploring the notion that venture capitalists have beneficial effects on the growth of new ventures when they rely on a set of distinctive skills and processes that we associate with venture capital capabilities. We bridge the venture capital and resource-based view research streams to identify the foundational mechanisms of venture capital capabilities. We develop a set of propositions to test empirically and discuss the implications of our study for research and practice.

Introduction

The growth of new ventures is an enduring issue in management research. Since Penrose's (1959) study, scholars have been investigating the constraints that influence the growth of new ventures, such as the liabilities of newness or smallness (Carayannopoulos, 2009), with the aim to explain variance in growth rates across nascent firms (see Gilbert et al., 2006 for a review). Interest in the growth of new ventures is not confined to the academic domain. The business press is filled with stories of charismatic and visionary founders who transform business ideas into successful business models. These stories generally depict a venture capitalist standing beside entrepreneurs (Florin, 2005; Zider, 1998). However, the capabilities that venture capitalists provide in facilitating new venture growth remains unclear.

Venture capitalists are conventionally depicted as providing new ventures with funds that more traditional channels, such as banks, are unlikely to grant given a new venture's lack of hard assets for securing debt. However, it has been increasingly recognized that venture capitalists play a strategic role in helping new ventures move from an entrepreneurial to a professionally-managed state (Zider, 1998). As a result, the influence of venture capitalists transcend the single firms and assures the competitiveness of entire ecosystems.[1] For example, venture capitalists promote breakthrough innovation (Ferrary and Granovetter, 2009). At the ecosystem level, venture capitalists serve as one of the more effective systems for indirect selection of new ventures, and they shape the environment where new ventures evolve (Baum and Silverman, 2004). At the firm level of analysis, venture capitalists influence the development of the ventures in which they invest through a combination of sorting/scouting effects and treatment/coaching effects (Bertoni et al., 2011). This has led to the observation that venture-backed companies have been found to outperform non-backed counterparts (Bertoni et al., 2013).

Literature has begun to explore the reasons behind the performance benefit of venture capitalists. Existing research about venture capital provides evidence that venture capitalists learn from repeated experiences to refine their abilities to scout and coach promising ventures (e.g., Petty and Gruber, 2011). Research also highlights that venture capitalists endow the ventures that they back with capabilities (Arthurs and Busenitz, 2006). Building on and extending these findings, we advance the idea that scouting and coaching activities may represent distinctive venture capitalists' capabilities, which allow them to create and capture value from the companies they back and to obtain competitive advantage vis-à-vis other venture capitalists.

If true, differences in venture capital capabilities can help to explain heterogeneities across the growth rates of venture-backed companies and across venture capitalists' performance because these capabilities affect the causal mechanisms (i.e.,

[1] Moore (1996, p. 26) defines a business ecosystem as "an economic community supported by a foundation of interacting organizations and individuals. This economic community produces goods and services of value to customers, who are themselves members of the ecosystem. The member organisms also include suppliers, lead producers, competitors, and other stakeholders." The concept of an ecosystem is broader than that of an industry or geographical cluster and includes both competitive and cooperative dynamics among the different actors of business life.

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value creation and value capture) through which organizational, environmental, and dyad-specific attributes lead to superior performance. Therefore, we aim to examine two research questions. First, what are venture capital capabilities? Second, what are the foundational mechanisms of venture capital capabilities? We explore these questions by building upon and integrating venture capital literature and the resource-based view to conceptualize scouting and coaching capabilities.

Our work offers several contributions. First, it contributes to venture capital research by extending the understanding of the mechanisms venture capitalists use to add value to venture-backed companies as well as the sources of persistent heterogeneities in the ability of venture capitalists to support new ventures' growth. It also contributes to the resource-based view (RBV) by conceptualizing two distinctive capabilities (venture capital capabilities) that develop within venture financing relationships. We also begin to disentangle the learning processes that lead to the development of capabilities. Third, we advance the broader strategic management literature regarding the dynamic growth of new ventures by unraveling the mechanisms venture capitalists use to help new ventures shift from an entrepreneurial to a professionally-managed state.

Theoretical background

Venture capital is far from a homogeneous phenomenon; it varies a great deal in terms of legal form, size and stage of investment, motives and criteria for investing, timing, and exit methods (De Clercq et al., 2006). Such variety is mirrored by the array of labels this phenomenon is given. Institutional (Bessler and Kurth, 2007), formal (Bruton et al., 2009), and professional investors (Gompers and Lerner, 2001; Hellman and Puri, 2002) are all terms used to distinguish venture capitalists from informal angel investors, who generally invest only their own funds and typically do so only in the early funding stages (Mason and Harrison, 2002). Our focus is on formal venture capitalists (for the sake of simplicity they are also referred to as venture capitalists). Our choice is driven by the longer history of the formal venture capital sector with an established set of common practices that enables drawing insights (De Clercq et al., 2006). Moreover, formal venture capitalists are generally more effective at nurturing new ventures (Vanacker et al., 2013). With this in mind, we now examine the formal venture capital investment cycle and its impact on the performance of new ventures. Our intent is to understand the degree of complexity and ambiguity among the activities that venture capitalists perform across the investment cycle and to identify how scholars assess the performance of new ventures. We pay particular attention to the use of growth dimensions and time intervals for measurement to identify distinct venture capital capabilities.

Venture capital investment cycle

Venture capital represents a special segment of the private equity industry associated with equity investments made for the launch, early development, or expansion of new ventures (Zider, 1998). Venture capitalists scan for investment opportunities to look for initiatives that have realistic chances of achieving significant growth and that offer an exit opportunity in three to seven years (Sahlman, 1990). The entire process is generally described as comprising three phases: (1) pre-investment, (2) post-investment, and (3) exit (Tyebjee and Bruno, 1984); see Table 1.

Pre-investment phase

The pre-investment phase involves deal origination, screening, evaluation and structuring (De Clercq et al., 2006). In the deal origination phase, the entrepreneur and the venture capitalist initiate contact and begin discussions with one another. This usually happens in networking events. If first impressions are positive, the venture capitalist moves on to screening the deal in terms of industry sector, investment stage, geographic location, and amount of capital needed (Shepherd, 1999; Zacharakis and Meyer, 2000). At this stage, there is a quick evaluation of whether the venture is a worthwhile investment.

If initial screening is positive, the venture capitalist engages in a due diligence process that involves a variety of information gathering methods and background checks. Overall, the literature highlights that venture capitalists focus on: (1) the venture's management team, (2) the market, (3) the product or service, and (4) the venture's financial potential as important elements in their investment decisions (Zacharakis and Meyer, 2000). If the business plan is realistic and achievable by the new venture's management, then the entrepreneur and the venture capitalist move on to deal structuring (Payne et al., 2009). This leads to setting the price of the equity securities (pre-money valuation) and the rules regarding the allocation of cash flows and control rights. If successfully completed, deal structuring eventually results in an investment.

Table 1
The venture capital investment cycle: phases and activities

Phase	Pre-investment	Post-investment	Exit
Activities	Deal origination Deal screening Deal evaluation Deal structuring	Monitoring Value-adding activities	Exit planning Exit method

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