

How do Entrepreneurs Raise Funds? An Inductive Study

Summary of Dissertation Proposal

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INTRODUCTION

The creation of new organizations is an important area of organizational theory, strategy and entrepreneurship research (Schumpeter, 1934; Stinchcombe, 1965; Hannan & Freeman, 1984). However, the creation and development of ventures requires that entrepreneurs¹ assemble resources, especially capital, to hire employees, rent facilities, and develop products and services (Bhide, 2000). Frequently entrepreneurs acquire this capital by selling portions of their ventures to investors who help their ventures grow and succeed by providing them with capital, advice, and status (Lee, Lee, & Pennings, 2001; Shane & Stuart, 2002; Hsu, 2004). Furthermore, certain investors provide greater advice and status than others (Barry, Muscarella, Peavy, & Vetsuypens, 1990; Megginson & Weiss, 1991; Hochberg, Ljungqvist, and Lu, 2005).

Given the importance of venture investors, such as venture capitalists, many researchers have taken the investors' perspective to study both the process by which investors search for ventures to invest in and the likely outcomes of this search. For example, organizational theorists have explored how investors use their social networks to investigate entrepreneurs in whom they are considering investing (Shane & Cable, 2002). Similarly, they have also used the concept of social embeddedness to explain how social ties between experienced venture capitalists allow them to invest in geographically remote ventures (Sorenson & Stuart, 2001). Using agency theory (Jensen & Meckling, 1976) and options theory (Black & Scholes, 1973; Merton, 1973), finance researchers have offered explanations of the prevalence of staged venture financing and common terms in investment contracts (Bergemann & Hege, 1998; Gompers, 1995; Kaplan &

¹ I use the term entrepreneur to refer to individuals involved in managing new ventures regardless of whether or not they were founders. I thus exclude individuals in existing organizations undertaking new initiatives within the organization.

Stromberg, 2004).

More recently, researchers have also begun exploring venture investments from the entrepreneur's perspective. Yet this research primarily focuses on why entrepreneurs might want investments, identifying benefits such as an improved chance of survival, faster sales growth, faster employee growth, reduced time to IPO and higher market capitalization at the time of IPO (Brav & Gompers, 1997; Bruno & Tyebjee, 1985; Chang, 2004; Lee, Lee, & Pennings, 2001; Shane & Stuart, 2002). While this research makes a compelling case for why entrepreneurs may desire investments, only recently have researchers begun to study how entrepreneurs actually find investments. For example, Ferraro (2003) studied how entrepreneurs raising their first round of financing developed social ties to investors, finding that it took time to nurture ties before they could be leveraged for fundraising. Zott and Huy (2005) studied a different aspect of finding investments, how entrepreneurs use symbols such as graduate degrees, luxury cars and prestigious office locations to convey legitimacy and uniqueness. Though thorough, these prior studies explore only narrow aspects of how entrepreneurs find investments.

To date, many of the micro-sociological processes by which entrepreneurs find investments therefore remain unknown and unexplained. For instance, how do entrepreneurs select which investors to approach? Do they select the most prestigious investors in their social networks, or are their selection criteria more sophisticated? Similarly, is it possible for entrepreneurs to influence investors and increase the likelihood of investment? Although social psychology studies on influence have traditionally emphasized dyadic means of influence such as escalating commitment and

reciprocity (Cialdini, Vincent, Lewis, Catalan, Wheeler, & Darby, 1975; Cialdini, 1978; Freedman & Fraser, 1966), might entrepreneurs instead influence investors by selecting the other investors with whom they will compete? What is the role of persistence in fundraising? It remains unclear whether entrepreneurs experiencing negative reactions in the first few meetings should continue approaching investors or whether they should temporarily abandon their fundraising to refine their business concept. Overall, many questions remain as to how entrepreneurs raise funds. To address these research gap, this dissertation studies the processes by which entrepreneurs attempt to and do raise funds.

METHODOLOGY

As prior empirical or theoretical research has not fully described the fundraising process and it is unclear which theories and concepts may be relevant to the fundraising process, an inductive approach was used (Eisenhardt, 1989a; Glaser & Strauss, 1967). Because relevant constructs were not fully known at the time of data gathering, open-ended case studies were composed by that each describes one venture's fundraising process at multiple units of analysis: (1) the venture's overall fundraising process, (2) experiences raising each round, and (3) the dyadic relationship with each potential investor. Although complex, using an embedded approach allows for richer, more reliable results (Yin, 1994). Multiple cases studies were gathered to improve the richness of the results and to ensure that observed patterns of behavior are robust (Eisenhardt, 1989a).

Overall, I developed 9 case studies that each describe fundraising in one venture from the Internet security market. The Internet security industry is an attractive setting because it contains a number of venture capital-backed ventures and unlike other settings such as biotechnology, entrepreneur status only weakly explains fundraising success

(Hallen, 2006). Furthermore, I restrict the sample to ventures founded in a single year, 2002, to control for fluctuations in the availability of investment capital over time (Gompers & Lerner, 1999). The 9 cases was developed through 32 semi-structured interviews with the entrepreneurs behind each venture as well as a subset of their investors. Each case documents how, across multiple rounds of fundraising, a venture's entrepreneurs and managers selected investors to approach, pitched their venture to these investors, and managed the investment process.

Presently, theory is being generated using replication logic across cases. Cases are being iteratively compared, with each case serving to confirm or disconfirm inferences drawn from the others (Yin, 1994). By looking for common phenomenon through rigorous within and across case comparisons, important but previously unrecognized factors are be identified (Miles & Huberman, 1994). Overall, the research is intended to produce a theory of how entrepreneurs raise funds that is empirically grounded, built on measurable constructs, and falsifiable (Eisenhardt, 1989a).

PRELIMINARY RESULTS

Though theory development is ongoing, I briefly discuss one preliminary finding here. I find that the success of entrepreneurs in raising funds depends on their ability to create competition between different investors. I observed that though many investors might initially express interest in investing in a venture, an investor is likely to only take steps towards investing (such as technical due diligence or introducing the entrepreneurs to other partners at the firm) if she feels that other investors are also in the process of taking similar steps. To create competition with the goal of ultimately receiving an

investment offer, I observed that entrepreneurs used a variety of mechanisms, including only approaching those investors whom they had identified as being interested in investing in the venture's market and geographic location (entrepreneurs typically determined this interest using their social networks), concurrently approaching a large number of investors (10 or more), and prioritizing attention to investors based on the steps the investors took in researching the venture. This finding is somewhat surprising as I find that creating investor interest depends primarily on the *a priori* creation of competition (similar to game theory (von Neumann & Morgenstern, 1947)) and not on the traditional means of influence identified in social psychology (Cialdini et al., 1975; Cialdini, 1978; Freedman & Fraser, 1966).

The study also promises to speak to other areas of organizational theory. Relevant to the literature on executive decision making (Jensen & Meckling, 1976; Wasserman, 2006), I find that entrepreneurs rarely attempt to play investors off one another to improve their venture's valuation. Additionally, and relevant to literature on the evolution of social networks (Gulati and Garguil, 1999; Sorenson and Stuart, 2001), I find that entrepreneurs exhibit a great deal of agency in determining their venture's initial network position with regard to investors. Overall, the research seeks to expand our understanding of how an entrepreneurs secure capital, of an important part of the entrepreneurship process.

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