Entrepreneur & Innovation Exchange
Published online at EIX.org on February 23 2024
DOI: 10.32617/1032-65d8c178db553

For VCs, Communities May Matter More Than Connections

Xiaoteng Wu (National University of Singapore)
Arzi Adbi (National University of Singapore Business School)
Pasha Mahmood (National University of Singapore)

KEYWORDS: Entrepreneurship, Venture Capital, successful startup, funding for startups.

Whether in the science parks of Shenzhen in China or the coffee shops of Silicon Valley in the United States, vibrant communities of investors, entrepreneurs, and experts drive progress by fostering strong bonds and sharing ideas and resources. For venture capital firms (VCs), tapping into communities can give them an edge over their competitors.

Access to communities also helps entrepreneurs and founders, because communities offer a strategic advantage in information acquisition and resource exchange. It can allow access to valuable knowledge and resources at lower costs, and can also foster trust and reciprocity through third-party referrals, which in turn enables access to broader networks. Thus, entrepreneurs and founders may significantly enhance their ventures' performance by leveraging not only direct but also indirect connections within their network communities.

Our new research published in the *Academy of Management Journal* (https://journals.aom.org/doi/abs/10.5465/amj.2022.0925?journalCode=amj) found that being part of a network community pays off in many circumstances, but not all. In parts of the world without credible third parties that collect information, analyze it, and rate companies, being part of a community was critical, and insiders fared better than outsiders. The presence of credible third-party institutions, located largely in developed economies, made membership in a community less important.

What We Studied

We arrived at these conclusions after we carefully analyzed the syndication networks of VC firms in China over almost 15 years. We used data from Zero2IPO, China's most comprehensive information provider for VCs, to look at 15,767 VC-year observations from 8,245 VCs between 2003 and 2016. This encompassed comprehensive information from 38,237 investment rounds, involving 26,484 portfolio companies. An algorithm called Clique Percolation Method, or CPM, helped us deconstruct a big network into smaller, comparable local networks consisting of highly clustered groups of VCs. Being part of a community implied being a member of a densely connected group.

How Network Communities Function

A network community of VCs refers to a group of VC firms interconnected through various relationships, either directly through co-investment partnerships or via indirect connections, such as partners' partners. These connections enable VCs within the community to access and share valuable resources, information, and opportunities, enhancing their ability to make informed investment decisions and support their portfolio companies more effectively.

Silicon Valley is known as a pioneering community, in which a group of densely connected VCs work together. This close-knit ecosystem fosters local innovation and entrepreneurship, giving rise to countless successful tech startups. However, geographical presence in Silicon Valley alone does not guarantee that a firm will be an integral part of this local community. Conversely, geographic boundaries alone do not dictate the boundaries of communities.

For example, hundreds of science parks are located in different provinces across China. VCs in markets like Shenzhen, Shanghai, and Beijing recognize the potential in the remote areas and actively participate in local network communities. They establish partnerships, provide mentorship, and invest in startups based in remote regions. The numerous online platforms connecting entrepreneurs with investors worldwide make these far-flung partnerships possible. They help bridge the gap between geographical boundaries and communities, enabling entrepreneurs from diverse backgrounds to connect with investors globally.

Communities vs. Connections

Communities can complement the conventional wisdom on the power of connections. Even though one VC may have the same number of connections as another VC, the two can vary in the number of network communities. One VC may be an *insider* (affiliated with at least one community), whereas the other VC can be an *outsider* (no affiliation with any community). We found that insiders are likely to outperform outsiders. The underlying reason is that being part of a community pays off for a VC, as it gains from indirect connections (partners of partners within the community). Such indirect connections can spread information about the VC's capabilities, making it easier to find and work with the best partners for critical resources. In turn, these insiders get better access to information and are less likely to make mistakes. Those outside the community risk being shunned and missing out on valuable information and resources.

We saw that communities matter less in areas of the world with well-developed third parties that provide standardized avenues for acquiring resources and information. For example, in the United States, third-party information intermediaries, such as rating agencies (Dun & Bradstreet), audit and consulting firms (PWC), and market research agencies (Nielsen) offer vital information about companies and their business environment, which can reduce the need for VCs to depend on communities. However, in many developing countries in Africa and Asia, the lack of such credible information intermediaries can amplify the benefits of communities. Therefore, community benefits will be greater when institutions are relatively less-developed.

Implications and Takeaways

Our research demonstrates the need to look more deeply at how and why it may not be just connections but communities that are key to superior performance. We saw that VCs that remain outsiders to these communities miss out on opportunities to recombine valuable capabilities. Our research suggests that managers and entrepreneurs will also be better off prioritizing developing meaningful community ties rather than just connections.

This means they may have to look both inward and outward to join communities and resist the urge to prioritize what is familiar nearby. They may want to harness new data sources and new tools to distinguish between connections and communities, thus helping them make better-informed decisions. This was an elusive task in the past, but modern techniques like CPM can make it possible.

Policymakers should also be aware of the potential for communities to benefit insiders and of their detrimental effect on outsiders. In developing economies without credible third parties, communities can be responsible for wealth concentration and socioeconomic inequity. Some companies may capture outsized gains, while others may get left behind. Until arm's-length market mechanisms mature, governments must sponsor important sectors to help outsiders become insiders. Done prudently, integrating companies into communities has the potential to yield more fair and sustainable growth.

In short, it is not just connections but also communities that can matter for firm performance, especially in the absence of well-developed institutions.

EXPLORE THE RESEARCH

The Social Structure of Insiders and Outsiders: Toward A Network Community Perspective on Firm Performance (https://doi.org/10.5465/amj.2022.0925) , Academy of Management Journal, Nov 2023

EIX.org (2024)
DOI: 10.32617/1032-65d8c178db553