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TITLE: Social capital in the capitalisation of new ventures: accessing, lubricating and fitting.

YEAR: 2009

In: Handbook of Business and Finance
Editors: M. Bergmann and T. Faust, pp.

ISBN 978-1-60692-855-4

Chapter 13

SOCIAL CAPITAL IN THE CAPITALISATION OF NEW VENTURES: ACCESSING, LUBRICATING AND FITTING

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ABSTRACT:

New venture capitalisation demands the formation of the necessary financial resources to launch. Social capital - the potential resources to which individuals have access due to their position within specific social networks of relationships - also plays a significant role in new venture capitalisation in three main ways. Firstly, social capital provides *access*, and thus acts a means of securing other forms of capital. Secondly, social capital also *lubricates* relations between entrepreneur and others within the socio-economic environment, including financiers. Thirdly, social capital acts as a mechanism for *fitting* the entrepreneur and their new venture to the wider socio-economic environment.

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INTRODUCTION

The capitalisation of new ventures is traditionally seen as the formation of the necessary financial resources to launch the venture. In this chapter we argue that social capital can also play a significant role. Social capital can be considered as the potential resources to which individuals have access due to their position within specific social networks of relationships. We consider three important aspects of social capital for the capitalisation of new ventures. First, social capital provides access, and thus acts a means of securing other forms of capital, which typically include human and intellectual capital, as well as finance. Social capital acts as an accessing mechanism by providing a bridging function from the entrepreneur to the locus in their networked environment where these resources are located. Secondly, social capital itself also functions as a complementary entrepreneurial asset by lubricating relations between entrepreneur and others within the socio-economic environment, including financiers. A major element of the liability of newness is the lack of credibility, and its stable mate legitimacy. Yet such reputational goods are essential in the yet to be born business. The entrepreneur's social capital can provide this legitimacy and thus legitimise the emergence of new business. By signalling trust and similarity, as well as "guaranteeing" certain ethical and commercial norms, social capital enhances interactions between individuals linked by network relationships. Thirdly, social capital acts as a mechanism for "fitting" the entrepreneur and their new venture to the wider socio-economic environment. Just as knowledge, information and norms about the new venture are transmitted to the networked environment, so the responses of that environment to the new venture – and its entrepreneur – are returned to the entrepreneur. These "messages" may be explicit or tacit, written or oral, formal or informal.; from a raised eyebrow and a withheld smile, to an email suggesting potential clients. Taken together, and acted upon by the new entrepreneur, this dynamic flow of market signals, mediated through social capital, "fits" the new venture to market needs, norms, and nuances. We continue by discussing the role of the social in enterprise and go on to explain how social capital has these three important roles to play in new venture capitalisation, with special attention to venture capital.

THE SOCIAL NATURE OF ENTREPRENEURSHIP

Lindgren and Packendorff (2002) propose that most conceptual accounts of the entrepreneur are usually embodied in a single person, but they argue that entrepreneurship is not the result of what single individuals do; it is the consequence of collective organizing and social interaction. Drakopoulou Dodd and Anderson (2007) claim that given the strength of the evidence of how entrepreneurship involves networked individuals and the networking of individuals, it seems difficult to conceive of entrepreneurship as the isolated act of an individual. Indeed, Johannisson and Monsted (1997: 112) argue, it is very likely we should see 'contemporary venturing activities as a partial mobilization of a slowly changing overall network'. Moreover, the importance of networking to venture success is highlighted by recent evidence that it is the lead entrepreneur in team starts who takes responsibility for networking, or, perhaps, the key networker in a team who becomes the lead entrepreneur (Neergard, 2005). This all stands as evidence that entrepreneurship is not an individualistic act and clearly shows that at all of the key stages of new venture creation entrepreneurship appears to progress through interaction with others. In this way, entrepreneurship can be understood as a social activity, where the economic is deeply embedded in social interaction (Jack and Anderson, 2002).

ENTREPRENEURS, NETWORKS AND SOCIAL CAPITAL

There is thus an increasingly accepted view that entrepreneurs are a product of their social environment and how opportunities are both perceived and realised is a consequence of social interaction and social background (Anderson and Miller, 2002). Although the actual process of entrepreneurship has been described as one in which “opportunities to bring into existence “future” goods and services are discovered, created and exploited” (Venkataraman, 1997: 120), more recently this process has been described as a social undertaking carried out within the context of social systems (Sarason et al, 2006). Entrepreneurs are embedded in a social context and in social situations (Steier and Greenwood, 1995; Kim and Aldrich, 2005). The role of relationships in organization formation has been widely examined (Larson, 1991; Larson and Starr, 1993; Steier and Greenwood, 1995; Hite, 2003; 2005). Studies have demonstrated that networks of relationships constitute a valuable resource for the entrepreneur (Nahapiet and Ghoshal, 1998; Davidsson and Honig, 2003; Batjargal and Liu, 2004). Consequently, the networks in which an entrepreneur is embedded; the ties he/she has to others, and the resources those ties can offer are important entrepreneurial venturing. Indeed Neergaard and Masden (2004) suggest that know who is as important as know how. Different clusters of ties offer “reservoirs of potential support” (Steier and Greenwood, 2000). So, a critical task for any entrepreneur is to make use of his/her existing network of relationships to mobilize necessary resources but also to work to enhance and strengthen that network of contacts (Steier and Greenwood, 2000). As Maula et al (2003) conclude, it makes sense for an entrepreneur to invest time and money to enable effective knowledge acquisition.

Accordingly, the central proposition of social capital theory is that networks of relationships constitute a valuable resource (Nahapiet and Ghoshal, 1998). By drawing on the social capital that exists in the network entrepreneurs are able to access other resources. But while possessing social capital might be useful, it is not a resource as such. The presence of social capital enables interactions which in turn may tap into resources (Anderson et al, 2007). Social capital represents a set of social resources embedded in relationships and which are available to people through their social connections (Baker, 1990; Coleman, 1990; Liao and Welsch, 2003; Lin, 2001; Kim and Aldrich, 2005; Anderson et al, 2007). It has been defined as “the features of social organisation, such as trust, norms and networks, that can improve the efficiency of society by facilitating coordinated actions” (Putnam, 1993; 167). Nahapiet and Ghoshal see social capital as “the sum of the actual and potential resources embedded within, available through and derived from the network of relationships possessed by individual or social units” (1998: 243). Similarly, for Bourdieu and Wacquant (1992: 119) social capital is “the sum of the resources, actual or virtual, that accrue to an individual or a group by virtue of possessing a durable network of more or less institutionalized relationships of mutual acquaintance and recognition”. The underlying assumption is that “networks of relationships constitute, or lead to, resources that can be used for the good of the individual or the collective" (Dakhli and De Clecq, 2004: 110). So, within the entrepreneurial venturing context it is assumed that social connections are used to obtain resources that would otherwise be acquired through expending human or financial capital (Kim and Aldrich, 2005). Entrepreneurs must surely then invest in social relations because there is some kind of expected return in the marketplace (Lin, 2001).

Social capital is therefore a social asset, even though unlike other assets it can neither be owned or borrowed. It can only be produced, re-produced and shared within social interactions. Descriptions of the content and associations invariably talk of trust, relationships, associability, interdependencies and networks. Barbieri (2003) concludes that all of the many meanings proposed consider social capital to be connected with the system of relations and social belongings in which individuals are embedded. It is not based on market transactions, though it may support such transactions and is often described as a means of reducing the cost and moral hazard of interaction (Anderson et al, 2007). Trust and interdependency, key aspects of social exchange, are important for building, generating and developing social capital. Fukuyama (1999) talks of informal co-operation and reciprocity between individuals. Interdependency, the coins of social exchange, are also perceived to be important for building, generating and developing social capital (Anderson et al, 2007). The network facilitates these interactions.

SOCIAL CAPITAL AND VENTURE CAPITAL

The financing of a new venture is central to the venturing process and given the importance of business creation to economic growth, it is important to understand how entrepreneurs obtain finance to exploit entrepreneurial opportunities (Timmons, 1994; Block and MacMillan, 1992; Steier and Greenwood, 2000; Shane and Cable, 2002). Aldrich and Martinez (2001) suggest that the resources required for creating a successful new firm consist of human capital, financial capital and social capital. As we explained above, social capital allows entrepreneurs access to other inputs that they do not possess. Liao and Welsch (2005) summarise this very well, talking about the general consensus that a high level of social capital built on a favourable reputation, expertise and personal direct contact often assists the enterprise in gaining access to venture capital.

This first role for social capital, "accessing" is well documented. Social capital has been described as a bridge (Anderson and Jack, 2002), a mechanism for connecting to assets that are not in the nascent entrepreneur's control, thus supplementing the entrepreneur's own resources. Social capital in networks improves entrepreneurial effectiveness by overcoming the liabilities of such resource constraints (Jack et al, 2004). Indeed, Davidsson and Honig (2002) argue that the presence of bridging and bonding social capital is a robust indicator of nascent entrepreneurship.

However the role of social capital is not limited to this direct "accessing" aspect. It also has two additional complementary functions; "lubricating" and "fitting". As a reputational good, social capital lubricates the interface between venture capitalists and the entrepreneur. Social capital can also provide a mechanism for fitting the proposed new business into the social, economic and technological landscape.

As a complementary asset, there is a growing realisation that social capital impacts on the decisions financiers make, particularly venture capitalists. Economic explanations for venture finance decisions are incomplete, undersocialised and ignore social ties (Shane and Cable, 2002). Financiers face difficult decisions when selecting who to support: entrepreneurs may act opportunitistically and of course, entrepreneurs vary in ability to identify and exploit opportunities (Macmillan et al, 1995). Thus seed-stage investors rely on social ties and relationships to select which ventures to fund, using social ties to overcome problems of information asymmetry (Venkataraman, 1997). Trust as Fukuyama (1995) explains is articulated in social capital. Nahapiet and Goshal (1998) explain the cognitive dimension of social capital as about shared values and shared meanings. Indeed Liao and Welsch (2005) discuss the similarities of this role to the institutional isomorphism of normative and mimetic forces described by Di Maggio and Powell (1993). In this sense, social capital allows and enables, as a signalling system, the drawing together of interests.

Indeed this connectedness can also be extended to see a governance mechanism. Drawing on the concept of embeddedness (Granovetter, 1985), Shane and Cable (2002) point out that organizational scholars have shown how social obligations between connected parties, and information transfer through social relationships, influence venture finance decisions. Anderson and Smith (2007), for example, describe how the moral dimension of entrepreneurship is both socially constructed and enacted, thus explaining social capital as a device for “approving” a new venture. Nonetheless, such explanations about the role of social relationships in venture finance have been criticised for being “unparsimonious and oversocialized”. Furthermore, while investors might exploit social ties to gather private information, it does not follow that investors make investment decisions based on social obligations (Shane and Cable, 2002).

Nonetheless, social capital as a reputational good is powerful. Fried and Hisrich (1994: 21) argue that “while VCs receive many deals cold (without any introduction), they rarely invest in them….Most funded proposals come by referral”. Shane and Cable (2002) argue that the reason why most funded proposals come by referral is that the referral provides information; and information about the individuals involved would seem to be key. Yet, to achieve this information, venture capitalists must surely draw on their networks of contacts. This implies that networks in which venture capitalists are embedded, their links to others and the social capital that resides within the network must impact on the venture capitalists decision making process. Moreover, Steier and Greenwood (1995) have illustrated that referrals can be critical in securing funding and that investors often participate in supporting a project because they have a relationship with a lead venture capitalist, “deal origination can be largely based on collaboration” (p.344). However, problems can also arise in that once involved, venture capitalists tend to take an active interest in promoting and managing the venture (Steier and Greenwood, 1995). Consequently, the relationship between the venture capitalist and entrepreneur can end up becoming about more than just finance and business advice as relationships become “multi-dimensional” exchange relationships (Macmillan et al, 1988; Timmons and Bygrave, 1986). Venture capitalists may providing access to other important networks which otherwise would be difficult to enter. (Steier and Greenwood, 1995). But, perhaps more importantly, relationships do not remain just social or economic by nature, instead friends become investors and investors become friends (Steier and Greenwood, 1995). As a result, friendships emerge, informal meetings and discussions take place and venture capitalists can become “personally troubled” when they have to withdraw funding from a venture: "the entrepreneurs had become their friends" (Steier and Greenwood, 1995, p.351). Through social interaction, social capital develops between the investor and the entrepreneur.

A final aspect of the complementarity of social capital is the aspect "fitting". By that we refer to how social capital can help shape a proposal, business idea or even an existing business to become more "attractive" to investors or stakeholders more generally (Jack et al, 2008). The ability of the new firm founder, as well as in the established firm, to capture external knowledge and expertise is vital, since no firm or individual is likely to own all such knowledge. Indeed, the employment of social capital in this conceptualisation is about transforming tacit knowledge, information and broad understandings into viable and appropriate applicable business acumen.

CONCLUSION

Figure 1 illustrates the roles we see for social capital. Such productions of social capital work with other forms of capital. Social capital is thus able to amplify, direct and focus the utility of other forms of capital. It may be seen as a complementary capital asset, but the operation of social capital works to overcome much of the liability of newness.

	Interpersonal Dimension	Community Dimension
Economic Aspects	Accessing- bridging to cash and other resources	Allocating– networked market function of getting resources to "right" loci and individuals
Legitimating Aspects	Lubricating – reputational good which smoothes relations and minimises information asymmetry	Norming – network level isomorphic effect of creating, transmitting and enacting locally legitimate norms
Knowledge Aspects	Learning- about norms and expectations	Fitting – community of practice shapes its members form and processes – perhaps especially new members – to fit.

Figure 1. Roles of Entrepreneurial Social Capital in the Capitalisation of New venture.

Moreover seen in this light, social capital is a convertible capital. It can be used to develop or tap into resources that would otherwise not be available. It may operate as a key to open doors which similarly, would not be accessible. It may also work to shape the emergent business to make it more attractive to venture capitalists. So social capital seems to play a critical role in the capitalisation of a new venture. It therefore follows that a critical task of any entrepreneur is to penetrate a venture capital network, to which there is a social dimension (Steier and Greenwood, 1995).

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