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**THIRD PARTY REFERRALS IN THE VENTURE CAPITAL FINANCING  
PROCESS: DO NETWORK TIES MATTER?**

**WORKING PAPER!**

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## ABSTRACT

In this paper we focus on the role of third party referrals in the venture capital funding process. Taking network theory as our theoretical perspective we explore if and how third parties play a role in the funding process. Hereby we focus on both the network ties between new venture teams and third parties and the network ties between VC's and third parties. To do so we collected in depth information on 25 venture capital investment decisions and studied how third parties played a role in three investment stages being (1) deal flow, (2) the initial meeting and (3) during due diligence. Our data shows some interesting findings. (1) When a third party is involved in connecting the new venture to the VC fund, strong ties between both the venture team and the third party and between third party and VC seem to be favorable. (2) At the initial meeting between new venture and the VC, third parties don't seem to play a role at all. And (3), during due diligence the role of third parties becomes important again as information source for VC's, however the effectiveness of particular network ties seems to be dependent on the type of information provided by the third party.

## INTRODUCTION

During the past decades researchers in entrepreneurship have shown the importance of networks to the entrepreneurial process. In venture capital research however, researchers have shown the importance of networks as well. In this paper, we look at the cross section of these two areas by studying one particular role network ties can play for new ventures and VC's, namely the use of networks ties as third party referral or informant. On the one side third parties are used by the new venture team to act as referrals and on the other side the VC uses third parties as informants in several stages of the investment process. In this paper we focus on the micro processes in the venture capital investment process and we explore if and where third parties play a role in the investment process. Added to this we also research whether existing network ties between venture teams and third parties and between VC's and third parties matter for a third party in order to be influential in particular investment stages. In this way we can explore whether the network of the new venture team or the network of the VC plays a more dominant role over the investment stages. This can have large implication for entrepreneurs, because it provides a fruitful insight in the controllability of the venture capital investment process. For example when it turns out that the tie between the new venture team and third party informant is important in a certain investment stage; this means that this stage can be actively controlled to some extent by explicitly using third party referrals.

By taking this approach we contribute to multiple streams of literature. First we contribute to network literature. Although many researchers have focused on the role of network ties in entrepreneurship, there are still many questions unanswered surrounding the effectiveness of strong and weak ties for entrepreneurs. In this paper we especially contribute to this literature by focusing on the role of tie strengths to third parties that could be helpful in acquiring resources, hereby focusing on multiple micro stages of the venture capital investment process. The micro processes of the investment process we identify are (1) deal flow (2) first meeting and (3) due diligence. Related to this we contribute to the literature on legitimacy, status and signaling by new ventures through the use of third parties. Although past research has shown how a variety of third parties can be beneficial to the entrepreneurial process, there has been a lack of focus on the actual network relations that are most effective for these third party referrals. Finally we contribute to venture capital literature, since current studies on venture capital decision criteria are mostly under socialized. However we expect that especially in early stage investments, the uncertainty and lack of information surrounding new ventures

will force VC's to look for other information signals. One of the information signals that can play an important role in this are third party referrals. Added to that we will study the effectiveness of network ties to these third parties for sourcing three types of information during the venture capital due diligence process, which has not been done in literature before. To conclude with we contribute to literature by combining network literature from a new venture perspective with literature from a VC perspective. By doing so we are able to show whether there are trade offs between the importance of entrepreneur network ties on the one side and the network ties of the VC on the other side.

We will proceed this paper with a literature review. After having identified the shortcomings in literature we will present our analytical model. Subsequently we will present and discuss our findings. This paper provides a lot of new insights into the role of networks on a micro level; however the paper also gives rise to interesting new questions. Therefore we conclude this paper with proposing some new areas for future research

## **LITERATURE REVIEW**

In this paper we try to combine literature from two perspectives. First we take literature that takes the perspective of new venture networks and researches how networks are beneficial to the entrepreneurial process. Secondly, we use the literature that focuses on the role of networks in venture capital deal flow and venture capital decisions. In this chapter we will discuss existing literature from these two perspectives.

### **New venture perspective: Networks and the entrepreneurial process**

In the past decades the research on social networks and their effects on organizations has grown rapidly (e.g. Aldrich and Zimmer, 1986; Birley, 1985; Hite and Hesterly, 1999). Two main discussions dominate the literature to date. The first discussion focuses on the structural characteristics of networks and discusses the effectiveness of closed networks vs. networks rich in structural holes (e.g. Burt, 1982, 1992, 1997, 1999, 2000, 2005; Coleman, 1972, 1988, 1990). The researchers that stress the importance of structural holes highlight the positive effects of diversity of information and brokerage opportunities in such networks. Researchers that advocate the advantages of closed networks stress the trust facilitating mechanism as main advantage in closed networks. Secondly, there is a relational network discussion between researchers focusing on the benefits of weak vs. strong ties to organizations (e.g. Granovetter, 1973; Uzzi, 1997, 1999).

Specific to entrepreneurship there are many studies that show the positive effect of networks to the development of new ventures. For example Zhao and Aram (1995) show in their study that entrepreneurs who are more involved in networking activities are more successful. As a result of this, researchers are researching the structural and relational network characteristics responsible for this positive relation and find that many contingencies are influencing the relation between networks and entrepreneurial outcome. For example Hulsink and Elfring (2003) find that the effectiveness of networks is dependent on the organizational process. Hite and Hesterly (1999) find that the effectiveness of networks is dependent on the life cycle stages and Groen (2000, 2005) claims that the role of networks in the entrepreneurial process is dependent on the type of technologies the venture is involved in.

When we look at current research we see that much research focuses on the direct provision of opportunities and resources to the new venture by their network contacts. However in this paper we focus not on the direct provision of resources by network contacts but on the

mechanism in which third parties and network ties can be helpful in getting resources from other parties. In entrepreneurship literature we find much evidence on third parties and their influence on new ventures. For example Burton, Sorensen & Beckman (2002) show that the prominence of prior employees is closely associated to the firm's initial strategy and the probability of getting external financing. Deutch and Ross (2003) show how the presence of reputable directors can be used by new ventures as a signalling mechanism. Khaire (2005) proposes that new firms with few financial resources and few avenues to obtain them grow by acquiring intangible social resources through networking. Thus she specifically focuses on the positive signalling effect of affiliating to high status customers. This positive signalling effect of customers is also shown by Reuber and Fischer (2005).

The positive effects of networks and affiliated parties have also been shown in the context of financing. For example Chang (2004) examines how the reputations of venture capital firms and strategic alliance partners have a positive impact on IPO success. Higgins and Gulati (2003) show how affiliations of new ventures impact the ability to attract prestigious underwriters. Stuart, Hoang and Hybels (1999) show how firms with prominent strategic alliance partners and organizational equity investors go to IPO faster and have higher valuations than firms that lack those connections. Shane and Stuart (2002) and Shane and Cable (2002) have shown that new ventures that have direct and indirect relationships with venture investors are more likely to attract venture funding and are less likely to fail. To conclude, many researchers have shown how third party affiliations and referrals are beneficial to the entrepreneurial process and the acquisition of financial resources.

### **VC perspective: Networks and venture capital financing**

We now turn our attention to the second stream of literature that we focus on, being the literature focusing on the role of networks in the venture capital funding process. Networks and third parties are not only important for new venture teams but also for people that work with new ventures and provide them with resources and information. In this paper we research on this area by focusing on venture capital. Venture capital and its decision criteria have been studied extensively in past research (e.g. Hall and Hofer, 1993; MacMillan and Zemann, 1987; Gupta and Sapienza, 1992; Zacharakis and Meyer, 1998 and Maula, Autio & Murray, 2005).

Within venture capital literature that focuses on networks, many researchers have shown the importance of third parties to the venture capital decision process. For example third parties play an important role for generating deal flow. The literature reveals differences in the number of deals that come to VC's by third party. Jugel (2001) found that 46% of the new deals come by third party referral. Vater (2002) found a percentage of 54 %, Wells (1974) a percentage of 61% and Tyebee and Bruno (1984) even find a percentage of 65%. These percentages show how dominant the role of third party referrals is in deal flow next to active search and cold calls. More interestingly, Fried and Hisrich (1994) find that deals that come by third party are more often funded than deals coming without any third party referral involved. Some researchers have also looked into the characteristics of third parties that VC's rely on for deal flow (Aram, 1989; Maula, 2001 and Stuart, Hoang & Hybels, 1999). For example Aram (1989) finds that business referrals are valued over third party referrals of friends and Stuart, Hoang and Hybels (1999) claim that third party referrals are particularly valued in areas where these third parties are perceived to have expertise.

Third parties not only play a dominant role in deal flow, they do also influence VC's in latter stages of the investment decision. For example Fiet (1995) compares the use of third party

informants by business angels and VC's in their decisions. He finds that VC's use formal network sources more often than business angels do. Added to that he finds that business angels prefer to rely on acquaintances instead of close contacts. VC investors however rely heavily upon associates at other venture capital firms, especially for market information. Related to these finding, Batjargal (2005) & Batjargal en Lui (2002) show how the referee-venture capitalist tie, referee-entrepreneur tie, and interpersonal trust between referee and venture capitalist have positive effects on third party referrals and investment decisions of venture capitalists. He claims that it will have positive effects when the aforementioned ties are strong.

### **The isolated nature of the two literature streams**

Having discussed the literature from two perspectives, I want to introduce one question that is of core interest in this paper, namely are there any trade-offs between the two streams of network research as discussed in the previous sections? Because if a new venture can use his network ties to overcome uncertainty at VC's and VC's rely on their turn on their networks to get deal flow and to acquire information during due diligence, could this mean that the one network is more prominent then the other. For example is the strength of tie between new venture and the third party he uses for accessing and informing VC's more important then the tie between VC and the third party involved?

## **SHORTCOMINGS IN LITERATURE**

Although many researchers have focused on the role of networks in financing new ventures, some areas can be identified in which there is still a lack of understanding. For example in the work on networks from a new venture perspective, the vast majority of studies focus on the role of networks in spotting entrepreneurial opportunities (Shane, 2000; Singh, 2000) and the direct acquisition of resources by new ventures using existing network contacts (Jenssen, 2001). However the question of how existing network ties can be used to access (unconnected) third parties and their resources is much less researched (Stuart, Hoang and Hybels, 1999; Shane and Stuart, 2002; Batjargal, 2005). Related to this, current approaches haven't focused on the actual effectiveness of existing network ties and tie strengths between venture teams and the third parties that could help new ventures getting funded. Furthermore, most studies on the role of networks in entrepreneurship fail to take a longitudinal approach (Hoang and Antoncic, 2003), therefore there is still little understanding on the development of networks and how they can be effective in different points in time. Related to that there is a lack of studies focusing on micro processes in venture financing (Wright & Robbie 1998). Mostly the characteristics of a new venture's network are used as an explanatory variable for some kind of outcome variable, thus focusing less on the exact micro processes that cause this specific relation. For example the value of strong and weak ties in acquiring resources are often researched without specifying which resource is acquired or without controlling for the characteristics of the entrepreneur that wants to acquire the resource (Jenssen, 2001).

Not only has the work from the new venture perspective faced shortcomings. The work from the perspective of the VC has many unexplored areas to date as well. For example research on venture capital and venture capital decision criteria often assume a rational actor that collects information, balances it and takes a decision. In this research, the social context in which a VC takes his decision is often overlooked (Maula, 2001). Although some researchers in venture capital decision making have taken into account third party referrals as a dummy in their studies, there is still a lack of understanding on the effectiveness of exact network tie strengths to these third parties. Added to that, research from the VC perspective also lacks

studies that focus on micro processes. This means that these studies often relate the value of third party referrals and networks to IPO or funding decisions (e.g. Batjargal, 2005; Chang, 2004; Higgins en Gulati, 2003; Shane and Stuart, 2002; Shane and Cable, 2002; Stuart, Hoang and Hybels, 1999), however there are many sub processes before taking a funding decision that could all be differently affected by third parties (deal flow, first meeting, due diligence). Added to this, researchers have also failed to relate the third party referrals that VC's use during due diligence to particular types of information, since it can be expected that the type of people used for due diligence depends a lot on the information sought for.

In this paper we will apply network theory to get a better understanding of the role that networks/third parties play in the VC's funding process from both perspectives (new venture and VC). Following the shortcomings in literature, there are three main questions we want to study in this paper. (1) Is the role of third parties important in the multiple investment stages (2) If so, do these third parties have existing ties to the VC and/or the new venture? (3) If there are existing ties, to what extent does the strength of the tie between the third party and the VC and/or the new venture matter?

### MODEL

In figure 1 an overview is presented of the model we use in this paper to overcome the shortcomings as identified in the previous chapter. What will do is to explore the importance and strength of existing network ties between the new venture team and the third parties involved and between the VC and the third parties involved in the venture capital financing process. By doing this we get a better insight in the importance of existing network ties and tie strengths. Added to that we are able to study the trade offs between the two ties, because as already discussed, existing approaches mostly focus on only one of the two ties.

We will do this in this paper by studying the third parties involved in three early VC investment stages, these stages are (1) Deal flow: We explore which third parties are involved in bringing new deals to the attention of the VC. By this we mean the third parties that are involved in arranging a first meeting between the new venture team and VC. (2) First meeting: We explore how third parties play a role when assisting the new venture team during a first meeting with the venture capital investment managers. (3) Due diligence: We explore which third parties are involved in due diligence. In other words, what kind of people do VC's rely on to provide them with information about potential investments. Since we divide the investment process into multiple micro stages, we are well able to see which ties are most prominent over the different stages, thus getting a better understanding of the role of networks in a longitudinal sense.

One additional dimension we include for the third parties involved during due diligence is type of information. Since we expect that the third parties that VC's rely on differs a lot for multiple types of information. By doing this we contribute to the venture capital literature since relating the type of third parties involved in venture capital decisions to the type of information they provide hasn't been done yet. Based on the venture capital literature, we make a division between three main types of information that actors could provide during due diligence. The multiple types of information we identify are: (1) Information on the technology and legal position: this concerns e.g. checking the quality of the technology and ability to protect the technology. (2) Information on the new ventures business model: e.g. market characteristics, strategy, positioning, pricing and marketing. (3) Information on the new venture team: e.g. background of the team, knowledge level of the team members, the

team's openness to advice, how the team deals with conflict and the level of skills the team members have.

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## **METHOD**

To examine our research model, we conducted structured interviews with ten early stage venture capital firms in The Netherlands. When discussing past investments, the VC's were asked to mention the network partners/third parties explicitly involved during the first three stages of the investment process. By this we mean that we focus on those third parties to which the VC had personally spoken to. Data were collected by conducting structured interviews with the venture capital fund managers. Since confidentiality is an important issue in venture capital, the interviews were not taped. However, information on third parties outside the scope of the structured interview was noted as well. Subsequently the data was checked with publicly available sources. In our analysis we combine the data of our structured questionnaire with the additional qualitative information on the third party referrals and information sources noted during the interview. In the questionnaire we asked a wide range of questions on the actors involved in the funding process. This includes information on e.g. an actor's reputation, power position, functional background, economic interest and social network. Tie strength between the VC and the third party was measured by three items derived from Granovetter (1973) (affinity, length of relation and contact frequency). The affinity between third party and new venture was scored by the VC as well. In this way we are able to create overviews over actors involved during the venture capital funding process and the ties between them. In this way we can identify potential patterns of network configuration that are most effective over the funding process.

During the interviews we discussed 20 funded propositions and 5 unfunded propositions with the VC's. Of the 20 funded propositions we studied the whole investment process. The 5 unfunded propositions are all examples of propositions that didn't manage to arrange a meeting with the VC because of the third party referral involved. We asked the VC's to come up with these unsuccessful third party referral examples in order to create variation in the successfulness of third parties involved in deal flow. This lead to a sample of 15 cases in which there was a third party referral involved deal flow. Ten times this third party referral was successful, however in five cases the VC's gave examples of third party referrals that didn't lead to a first meeting (as just stated, we asked for examples in which the third party characteristics were the main cause to not meet with the venture in 5 cases). During the interviews we also collected in depth information on third parties that the VC's consulted during due diligence (when this stage was entered for the specific proposition!). For those 20 proposition that entered due diligence, we asked the VC's to come up with one example of someone that played an influential role in their due diligence process. This lead to a sample of 19 third parties that played an influential role in the due diligence process, since in one of the cases the VC didn't consult any third party during due diligence. Of these 19 third parties, 5 provided information on technology, 12 provided information on the business model and 8 provided information on the team.

## **RESULTS**

### Deal flow

The first stage of the venture capital investment decision in which we explore the role of third parties is deal flow. However before we discuss the actual third parties involved we will discuss some statistics collected during the interviews to give some more background on this stage of funding. To start with we found that the number of deals the VC's in our sample screen every year ranges between 50 and 600, on average VC's receive 196 requests for financing every year. Related to the topic of this paper we found that the percentage of deals that comes to VC's through third parties ranges between 20% and 90%. On average, in about 51% of the deals that reach VC's there is a third party involved. This means that in more than half of the cases it is a third party and not an entrepreneur that is responsible for the initial connection to VC's! Next to these statistics we also discussed the most important sources of deal flow of VC's. Of the ten VC's we interviewed, six indicate their network as the most important source of deal flow. Two VC's see new venture teams coming directly to them as dominant source of deals and two VC's see active scouting as most important source of deal flow. There are many reasons why VC's prefer deals that come through their networks or third parties as opposed to deals coming through other channels. In the following summary we show some quotes we collected during the interviews that show the advantages and importance of deals coming through third parties. The summary shows a variety of reasons why third parties can play a positive role in getting access to new deals.

Quote 1	"I don't look at deals that come by mail by definition. Problem with email is that many entrepreneurs send around their business plans without having checked our basic investment criteria."
Quote 2	"When deals come by mail I am a bit sceptic, because then I know that at least 10 other VC's have seen as well. This takes away the exclusivity of the deal, which is something that we value a lot. "
Quote 3	"When a deal come by a third party, say a corporate finance house, it shows that the entrepreneur is willing to let other people help him. We often meet entrepreneurs that don't have much knowledge on financing, but who did not consult any professional in financing before coming to us. This looks to us as being very unprofessional"
Quote 4	"I can surely say that third party referrals are very important to our deal flow. Looking the propositions that reach us, I can say that we have talked to many entrepreneurs that we wouldn't have talked to when there was no third party involved"
Quote 5	"When looking at our portfolio, we see that most of the firms we invested in came to us through our networks. We have hardly funded ventures that came to us outside our network. I think I can say that the quality of the ventures that contact us directly is much lower".
Quote 6	"Since our focus is on the region, we take the tips we get from third parties



	very serious. When we don't do this they will probably don't come to us in the future."
Quote 7	"The investment community is rather small; everyone knows pretty well where a particular VC is looking for. So when we get tips of other VC's, we know that it will be within our scope of investment."

Although the quotes show that third parties can be beneficial to new ventures in connecting to VC's, the success of a third party referral is obviously very much dependent on the characteristics of the third party involved. In this paper we focus on two of these characteristics of the third party involved, being their network ties to the VC and to the new venture. During the interviews we identified 15 third parties that were involved in deal flow. In ten cases this led to a first meeting with new venture team and in five cases it didn't. In table 1 we give an overview of the people involved in connecting VC's to new deals and their tie strengths to the VC and the new venture. Added to that we also indicated whether the third party referral led to a first meeting.

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Table 1 gives some interesting insights in the importance of network ties for deal flow. First of all it shows that in all the successful referrals, there was an existing tie between the VC and the third party. Also, when looking at the unsuccessful third party referrals, the table shows that in three of the five cases the VC didn't have an existing tie to the third party. This result clearly indicates that an existing tie between VC and third party has a positive effect on the chance that a third party referral will lead to a first meeting. When looking at the strength of ties between VC and third parties during deal flow, the table clearly shows evidence that stronger ties are more favorable over weak ties between VC and third party.

When looking at the tie between third party and new venture, the table shows evidence as well that a strong tie between third parties and new ventures is as well favorable to access VC funds. For the successful third party referrals, the VC's indicated that the ties between third parties and new ventures were stronger then for the unsuccessful third party referrals

### **First meeting**

The second stage in which we wanted to explore the role of third parties is during the first meeting. On average the VC's in our sample meet 69 new propositions a year, varying between 25 and 125. During the interviews we found evidence that the role of third parties is very small during this stage. Although third parties can play important roles when connecting entrepreneurs to the VC, this effect does not hold during the first meeting.

Quote 1	"To come back to the role of networks in our financing process, I can say that in this stage networks hardly play a role. A third party might have helped in arranging a connection to us, however once in our first meeting it is up to the entrepreneur himself."
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Quote 2	“In this stage we want for example find out if the entrepreneur is a salesman. He can have a brilliant technology, but when he cannot sell it’s useless to us”
Quote 3	“When we first meet the entrepreneur, we want to find out what kind of guy he is. Very important in this is that their must be a click between us and the entrepreneur, simply said we must like the entrepreneur ”
Quote 4	“When an entrepreneur is in mostly the basic characteristics of the deal are OK. During the meeting I mainly want to find out if the guy is the one that can build the company, since execution is the most important to any idea.”

During the first meeting it is really about the new venture team itself. Before meeting the new venture team the VC already makes sure that the basic criteria of the deal are matching their criteria (market size, scalability, focus, proprietary technology etc.). During the meeting with the new venture team it is really about the team itself and the VC’s indicate that third parties do not play a role. During the first meeting the VC’s main focus is on the characteristics of the new venture team e.g. their first impression, coach ability, openness, integrity and the fact that the team has a consistent story.

### **Due diligence**

The last stage in the decision process before deciding to invest is due diligence (DD). During due diligence the VC wants to decrease uncertainty as much as possible by checking the information they possess about the proposition. Whereas in latter stage investments the due diligence work is often done by external firms, due diligence in early stage investing is often done by the VC himself. There are two main reasons for this. First, the VC doesn’t want to rely on external judgment to base an investment on. However there is also a more practical reason for this, being the costs of due diligence. Since the investments in early stages are usually lower than in latter stages, the size of the investments in early stage high-tech new ventures often don’t justify the relatively high costs of an external due diligence.

During due diligence the VC makes use of a variety of information sources like public available information, network contacts and other third parties. In this paper we focus on third parties as an information source during due diligence. Again we state some quotes we collected during our interviews that show the importance of third parties as an information source. On average the VC’s we interviewed indicated that on average that they contact 6,3 third party informants during the due diligence stage. However the number of third parties contacted (outside the venture capital firm!) ranges between 0-20.

Quote 1	“I once invested in a company that I had hardly spoken to. I met the entrepreneur myself only once. For the rest of the due diligence I completely relied on an other venture capital firm, since it was a syndicated deal.”
Quote 2	“We once invested in a venture without doing due diligence myself, since a friend of mine assured me that everything was OK. The venture went bankrupt in 4 months, so I will never invest without conducting my own due diligence

	again!”
Quote 3	“When other VC’s want to co-invest, this is a very important signal to us”
Quote 4	“During due diligence we always call 5 (potential) customers, because to us this are the most important stakeholders to us that determine the success of a firm.”
Quote 5	“We prefer to conduct our own due diligence. Most of the knowledge we need to judge proposition we have in house, however especially for technology we rely on our network of contacts”
Quote 6	“For this proposition it was very important that the professor was enthusiastic about the technology, otherwise I think we would not have had invested”

Third parties are an important information source during due diligence, and in this paper we want to focus in depth on the importance of network ties to these third parties. However before we continue to discuss the network characteristics of third parties involved during due diligence, we want to highlight again that we relate the information provided by the third parties to three types of information. These three types are (1) information on technology and legal issues regarding the technology (2) business model information and (3) information on the new venture team. During our interviews we collected in depth information on 19 third parties that played an important role in a VC’s decision to invest. We will subsequently discuss the importance and presence of network ties between third party and VC and third party and new venture for the 3 types of information areas.

### ***Technology information***

When we asked the VC’s for the most important third party involved in their investment decision, they came up with five third parties involved in technology due diligence. In Table 2 we summarize the characteristics of these third parties. In three of these five cases the VC hadn’t an existing relationship to the third party. Therefore table 2 seems to indicate that an existing tie to the VC is not really needed for a technology information source to be influential. The table indicates as well that a tie between third party and new venture doesn’t have a favorable affect in order to be more influential. In three of the five cases the VC’s relied on a third party referral that wasn’t connected to the new venture team in any way. To summarize it seems that for technology information existing ties between the third party and VC and the third party and new venture don’t matter.

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### ***Business model information***

During our interviews we found 12 third parties that provided important information on the business model. In Table 3 we give an overview of our findings. When we look at the tie between these information sources and the VC, it seems to be that VC’s tend to rely on people that they have existing relations to. Added to that they tend to rely on people that they know very well, so have strong ties to. One exception to this is the role of customers as a source of information. In two cases the VC contacted and relied heavily on someone they didn’t know

beforehand and in both of these cases this was a customer. Therefore it seems that customers have a special role in the due diligence process, since network ties seem less important for them in order to be influential. When looking at the ties between the third party referrals involved in providing business model information and the new ventures, we see that in eight of the 12 cases they have a tie. When looking at these eight cases, the strength of tie doesn't seem to play a big role. In four of the 12 cases they hadn't even any tie, so the tie between new venture and a third party information source doesn't seem to be very important for the provision of information on the business model.

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### ***New venture team information***

The third and last type of information we identified was information about the new venture team. During the interviews we identified eight third parties that provided information on the new venture team. As can be derived from Table 4, the finding for the tie between third party and the VC is similar to the finding on business model information. In six of the eight cases the third party had a strong tie to the VC, indicating support for a favorable effect of a strong and existing tie. In two cases however, the VC relied on someone they didn't know beforehand. Again in both cases this was a customer, indicating again a special role of customers in the due diligence process. When we look at the tie between the venture team and the third party, Table 4 shows that in all cases the third party knew the venture team. This is evident since this is the reason why the VC contacts the third party in the first place. There was no case in which the VC indicated that the third party and the new venture knew each other "very little", indicating support for the claim that the VC wants to rely only on third parties that are strongly tied to the new venture.

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## **CONCLUSIONS & IMPLICATIONS**

Before discussing our contributions to literature and practice we shortly summarize our findings. In table 5 we give an overview of our results. First of all we find that the role of third parties in the venture capital funding process is most prominent for deal flow and during due diligence. When delving into the findings from a new venture perspective we see that there are two events in which a tie between the new venture and the third party has a positive contribution to the financing process. First it seems that a strong tie between the new venture and the third party referral has a positive effect when using this third party to get access to venture capital funds. Secondly our findings show that a strong tie between the new venture team and third party is favorable when this third party is consulted by the VC regarding information about the team during due diligence. For the other events in the venture capital investment decision, our results don't show evidence of positive effects of ties between the new venture and third parties.

When shifting to the findings from a VC perspective we find that VC's tend to rely on strongly tied third party referrals for deal flow. During due diligence however we find a

mixed pattern. For technology information an existing network tie between VC and the third party consulted by the VC doesn't seem to matter. However for business model information and team information we find evidence that VC's rely on strongly tied third party referrals.

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 Insert Table 5 about here  
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Our approach to explore the role of third parties over the venture capital investment process adds to network literature in several ways. First of all, by focusing on the third parties involved over the venture capital funding process, we give more insight in the role that networks and third parties can play in order to get access to resources of unconnected actors. Previous studies fail to focus on this mechanism and mostly focus on the direct provision of resources by network contacts. By taking this approach we also add to the status and legitimacy building literature since it shows how and when third parties can be used to signal status and legitimacy. For example our results show (see table 5) that the signaling effect of strong ties third parties is most prominent when accessing funds and for due diligence on the team. However for sourcing technology information and business model information by VC's we don't find this positive signaling effect of new venture network ties to third parties, since the VC value their own network ties far more for these types of information. A related contribution to network theory is our focus on studying the ties between three actors (the venture, the third parties and the VC). By studying the ties between 3 actors we could also study tradeoffs in the network of entrepreneurs and other stakeholders (VC's) that are often overlooked in literature. Because many studies only focus on dyadic network relations, there is still little understanding on the effectiveness of triadic network relations. Our results clearly show how the importance of the VC-third party and the third party-new venture tie is dependent on the stage of investment. This dynamic importance of ties gives much more insight to the funding process than if we had only focused on one of these ties. A third way in which we add to network literature is that we studied the role of network ties over different stages of the investment process. Our results clearly show how the importance of networks and network ties is different over the stages of the investment process. Therefore we show how important it is to clearly define and focus on particular processes when studying the role of networks in entrepreneurship. When not doing so, one wouldn't do justice to the complexity and importance of network mechanisms on micro levels. A final contribution to network theory is that we go one step beyond the general assumption in network literature that weak ties are important for information and strong ties important to facilitate trust. Up to now, literature showed that weak ties will have a positive effect on the acquisition of new information. However, our results indicate that the effectiveness of certain network ties is dependent on the type of information acquired by VC's during due diligence as well.

This paper also extends the venture capital literature in several ways. First of all we add to the literature by focusing in depth on the social context of venture capital decisions. Although multiple researchers have made claims on the importance of the social context of venture capital decisions (especially in early stage investments), this context is still very much overlooked in prior venture capital research. An additional contribution to literature is that we focus on multiple micro processes in venture capital decision making. Current studies on venture capital deal flow and venture capital decision criteria are mostly conducted by focusing on a certain stage of the venture capital decision process. However there is still much unknown about the dynamics of venture capital decisions and for example the importance of certain decision criteria over the different stages of the investment process. In our paper we do

focus on these dynamic, for example we show that there are two points in which existing network ties play an important role in the funding process. First of all we show that existing network ties play an important role in connecting new venture teams to venture capital funds. Added to that we find that VC's for deal flow tend to rely on third party referrals they have strong ties to. Subsequently we find that networks play a minor role during the first meeting with the VC since it is up to the new venture team itself in this stage. However we find that networks do play an important role again during due diligence. This last result is another way in which we add to the venture capital literature, because we study the role of networks as information source during due diligence in greater detail. Although some studies take into account a third party referral as a dummy variable, there are hardly any in depth studies that look into the nature of network ties to these third parties. Very interesting finding in this respect is that the role of existing network ties during due diligence is different for different types of information. For example we found that for technology and legal information networks ties between VC and third party don't seem to matter, whereas for business model and team information VC's tend to rely on third party informants they have strong ties to.

Our paper has large implication for practice, especially for the practice of entrepreneurship support. For example, since we know more about the types of third party referrals that are most influential over the venture capital decision process, we are better able to select the people that can support new venture teams in acquiring venture capital funding.

### **LIMITATIONS & FUTURE RESEARCH**

A first direction for future research is to extend the research in a quantitative sense. This will enable us to test whether the relations we find in this paper hold statistically.

A second area of future research is to approach the funding process of VC's in a multi dimensional way. By this we mean that we should take into account other characteristics of the actors in the venture capital funding process instead of just the network ties. This is supported by our findings, since for example customers seem to play a special role in the due diligence process which cannot be solely explained by network ties. Although this paper provides a fruitful insight into the role of networks in the funding process, it would be interesting to see how the importance of network ties is influenced by the characteristics of the actors involved. For example it would be interesting to research how the importance of network ties is influenced by for example the strategic, economic and cultural characteristics of the third party referral, VC or new venture. In this way we will be better able to articulate the exact contingencies that influence the importance of network ties. Related to this it would be interesting if the network effects that we find in this paper are a direct effect or whether networks play a more indirect role. For example it could be that network ties don't cause a direct effect on the funding decision, but that networks are having a moderating effect on the perception of a new venture's strategic, economic or cultural capital.

To conclude with we propose one other direction for future research, namely the application of our approach to the acquisition of other resources. It would be very interesting to research whether the role of networks for acquiring knowledge or personnel is different compared to the acquisition of financial resources. By doing so, we will be able to develop networking strategies for entrepreneurs for multiple types of resources.

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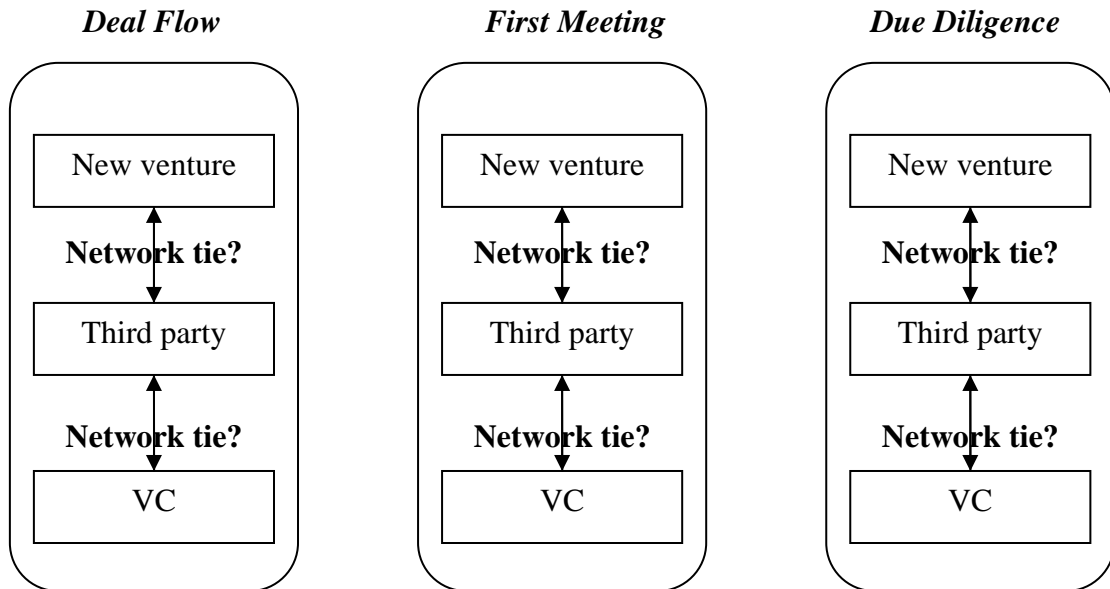


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**FIGURE 1**

**Analytical Model**



**TABLE 1****Third Party Referrals Involved in Deal Flow**

<b>Type of Third Party Referral Involved in Deal Flow</b>	<b>Third Party-VC Tie (Strength)</b>			<b>Third Party– Venture Team Tie (Strength)</b>	<b>Was the Referral Successful ?</b>
	<i>Contact length in years</i>	<i>Contact frequency</i>	<i>Contact intimacy</i>		
	<i>Contact length in years</i>	<i>Contact frequency</i>	<i>Contact intimacy</i>	<i>Contact intimacy</i>	<i>Y/N</i>
<b>Other VC</b>	10	Monthly	Very well	Very well	Y
<b>Accountant</b>	5	Monthly	Somehow	Very well	Y
<b>Bank</b>	15	Monthly	Very well	Very well	Y
<b>Other VC</b>	2	Monthly	Very well	Very well	Y
<b>Personal network</b>	3	Weekly	Very well	Very well	Y
<b>Accountant</b>	-	-	-	Somehow	N
<b>Other VC</b>	5	Monthly	Somehow	Somehow	Y
<b>Chamber of commerce</b>	1	Yearly	Very Little	Very Little	N
<b>Board member</b>	7	Monthly	Very Well	Very Well	Y
<b>CF advisor</b>	-	-	-	Somehow	N
<b>Bank</b>	5	Weekly	Very well	Very well	Y
<b>CF advisor</b>	7	Yearly	Very little	Somehow	Y
<b>Personal network</b>	2	Yearly	Very little	Somehow	N
<b>Personal network</b>	5	Yearly	Very well	Very well	Y
<b>Consultant</b>	-	-	-	Somehow	N

**TABLE 2****Influential Third Party Informants during Due Diligence for Technology Information**

<b>Type of Third Party Involved</b>	<b>Third Party-VC Tie (Strength)</b>			<b>Third Party-Venture Team Tie (Strength)</b>
	<i>Contact length in years</i>	<i>Contact frequency</i>	<i>Contact intimacy</i>	
<b>Professor</b>	6	Monthly	Somehow	-
<b>Technology specialist</b>	10	Monthly	Somehow	-
<b>Law specialist</b>	-	-	-	Somehow
<b>Technology specialist</b>	-	-	-	-
<b>Technology specialist</b>	-	-	-	Very well

**TABLE 3****Influential Third Party Informants during Due Diligence for Business Model Information**

<b>Type of Third Party Involved</b>	<b>Third Party-VC Tie (Strength)</b>			<b>Third Party– Venture Team Tie (Strength)</b>
	<i>Contact length in years</i>	<i>Contact frequency</i>	<i>Contact intimacy</i>	<i>Contact intimacy</i>
<b>Board member</b>	10	Monthly	Very well	Somehow
<b>Director company</b>	5	Monthly	Very well	Very little
<b>Director company</b>	20	Monthly	Very well	-
<b>Shareholder of VC</b>	15	Monthly	Very well	Very well
<b>Director company</b>	4	Monthly	Very well	-
<b>Customer</b>	5	Monthly	Very well	Very well
<b>Customer</b>	-	-	-	Very well
<b>Other VC</b>	10	Monthly	Very well	Somehow
<b>Board member</b>	6	Monthly	Very well	Somehow
<b>Director company</b>	7	Monthly	Very well	-
<b>Consultant</b>	10	Yearly	Somehow	-
<b>Customer</b>	-	-	-	Somehow

**TABLE 4****Influential Third Party Informants during Due Diligence for New Venture Team Information**

<b>Type of Third Party Involved</b>	<b>Third Party-VC Tie (Strength)</b>			<b>Third Party-Venture Team Tie (Strength)</b>
	<i>Contact length in years</i>	<i>Contact frequency</i>	<i>Contact intimacy</i>	
				<i>Contact intimacy</i>
<b>Major of town</b>	12	Monthly	Very well	Somehow
<b>Shareholder of VC</b>	15	Monthly	Very well	Very well
<b>Customer</b>	5	Monthly	Very well	Very well
<b>Customer</b>	-	-	-	Very well
<b>Other VC</b>	10	Monthly	Very well	Somehow
<b>Board member</b>	6	Monthly	Very well	Somehow
<b>Customer</b>	-	-	-	Somehow
<b>Other VC</b>	6	Monthly	Very well	Very well

**TABLE 5****Summary of Results**

	<b>Importance of Third parties</b>	<b>Importance of Third party-Venture team tie</b>	<b>Third party-Venture team tie (Strength)</b>	<b>Importance of Third party -VC tie</b>	<b>Third party -VC tie (Strength)</b>
<b>Deal flow</b>	+	+	Strong	+	Strong
<b>First meeting</b>	-	-	NA	-	NA
<b>Due Diligence -Tech info</b>	+	-	NA	-	NA
<b>Due Diligence -BM info</b>	+	-	NA	+	Strong
<b>Due Diligence -Team info</b>	+	+	Strong	+	Strong