Venture capital investors with competing interests can inhibit innovation

October 15 2015, by Ed Kromer

For entrepreneurs, connections are as good as gold. Especially connections with the right investors.

But connections with the wrong investors can inhibit a firm's ability to innovate, according to new research by Emily Cox Pahnke and Benjamin Hallen, assistant professors of management at the University of Washington Foster School of Business.

Their paper, "Exposed: Venture Capital, Competitor Ties, and Entrepreneurial Innovation," is in the October issue of the *Academy of Management Journal*.

In their study of medical device makers, Pahnke, Hallen and their co-authors document a siphoning of valuable information that can occur when firms are indirectly tied to a direct competitor via a shared venture capital investor.

Most vulnerable to this innovation-hindering leakage are firms whose investors are:

- geographically distant from them, because venture capitalists take a more active advising interest in nearby firms;
- less financially committed to them, because venture capitalists are more likely to share information with competitor firms in which they are more invested or reinvested; or
- new to their industry, because a venture capital firm is most

likely to learn from its first investment and share it with subsequent investments in the same industry.

"Lacking power, status and resources," Pahnke says, "entrepreneurial firms wield little sway over the relationships that their investors form with other firms and may have little control over what information gets shared."

To understand the effect of entangled venture capital alliances on innovation, Pahnke and Hallen collaborated with Rory McDonald of Harvard Business School and Dan Wang of Columbia University to study 22 years of activity in the minimally invasive medical device industry. Integrating 30 distinct data sources, they compiled a full picture of the companies and their investors, and identified the instances in which venture capitalists invested in two firms in the same sub-segment of the industry.

This is not uncommon. Among venture capitalists in the medical device industry, the study revealed that 20 percent were invested in direct competitors at the same time.

These competing interests give rise to what the authors term "competitive information leakage." This leakage impedes the firm's ability to produce innovative products, as measured by FDA approval—a rigorous process that requires a device to improve upon existing devices in terms of patient outcomes. Just as good isn't good enough.

"If someone gets a device approved ahead of you, it delays your own approval because you're going to have to invent around them," Pahnke says.

She adds that the sharing of information by investors from one firm to another is rarely done intentionally, or even consciously.

A venture capitalist's first investment in an industry may encounter problems they've never seen before—a regulatory hitch or engineering problem, for instance," Pahnke says. "So when another of their investments encounters a similar problem, they can offer advice on the solution. It's not that they are deliberately leaking secrets. They may not even consciously realize that the solution came from an interaction with another one of their investments."

So what is an entrepreneur to do? The study identifies instances in which a venture capitalist-funded firm is more or less vulnerable to competitive information leakage.

Less vulnerable are firms that are located near their shared investor, that are not their investor's first in a given industry, and that have seen sustained interest from that same venture capitalist.

More vulnerable are firms that are their shared investor's first in an industry and that are geographically distant from their investor.

High-status venture capitalists, who have more connections, tend to have a greater sharing problem. "Later investees glean wisdom from earlier ones," Pahnke notes. "You want an investor who knows your market, but you don't necessarily want them to learn the market from you."

The message to entrepreneurs: Be cautious.

"If you were forming a direct relationship with a competitor—some kind of alliance—you'd be very careful about what you told them," says Pahnke. "But when you're forming a relationship with a venture capitalist, you have to be very open about everything. You don't have control of what goes to your competitor and how."

Still, capable entrepreneurs with marketable businesses should be able to navigate the pitfalls of competitive information leakage.

"The hope with this paper is not to make entrepreneurs view their relationships with venture capitalists as adversarial, but rather urge them to consider the risks as well as the benefits," Pahnke says.

"Raising venture capital is hard, and entrepreneurs rightly get really excited about it. But good entrepreneurs have multiple options for investors and should be very thoughtful about which investors they take on."

More information: E. Pahnke et al. Exposed: Venture capital, competitor ties, and entrepreneurial innovation, *Academy of Management Journal* (2014). DOI: 10.5465/amj.2012.0777

Provided by University of Washington