The power play between venture capitalists and CEOs shapes startup innovation

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Our research explores how venture capitalists (VCs) and chief executive officers (CEOs) jointly affect the risk-taking behaviour of a startup — manifested through innovation novelty over the new venture's different life stages. We show that VCs behave differently for each stage. They generally encourage startups to take high risk by pursuing novel innovations early on. In later stages, VCs tend to encourage less risky, more incremental, innovations. This is because VCs are typically sitting on potential profits that they do not want to risk losing in a more mature new venture.

However, this tendency is strengthened or attenuated depending on the power dynamics between VCs and the startup's CEO. We consider two sources of power that CEOs can rely on. One is their **structural power**, or the number of job titles they hold. This source of power gives them the ability to influence the agenda of a new venture by controlling its information flow and decision making. CEOs with structural power also tend to be more optimistic and future-oriented due to their perceived job security. We argue and show that startups led by CEOs with high structural power are likely to strengthen the positive effect of VCs in pursuing risky, novel innovations in the early stages and attenuate the negative effect of VCs in pursuing less risky, incremental innovations in the later stages.

Another source of power for startup CEOs stems from **their prior experience** with inventing activities, or what we call "expert power". We argue and show that startups led by expert CEOs take a more balanced approach to innovation-related activities given their experience with inventing activities. As such, they are likely to attenuate the influence of VCs in encouraging the startups to pursue risky, novel innovations early on, to appropriately balance risk and outcomes during this stage. Likewise, startups led by expert CEOs are also more prone to attenuating the VCs' influence in pursuing less risky, incremental innovations in later stages.

Our research was conducted based on a sample of 482 biotech firms in the U.S. that received VC funding between 1973 and 2003. Biotechnology is at the intersection of molecular biology, immunology, genetics, and chemistry. The integration of this new set of technologies has the potential to transform various fields – pharmaceuticals, chemicals,

agriculture, veterinary science, medicine and waste disposal. These transformational opportunities joined with intense competition for patentable know-how creates incentives for startups to generate novel innovation. We measure innovation novelty at different stages of a startup by looking into whether the patents it filed follow the conventional knowledge structure of similar patents or deviate from that. Deviation would indicate that startups might be pursuing risky, novel recombination of different types of knowledge that have not been recombined before.

Our study sheds new light on the VC-CEO relationship and provides insights into how the risk preference and the abilities of mutually dependent actors affect the innovation outcomes of new ventures. The findings of this study could help VCs and startups to choose the best CEO depending on their objective – and provide insights on how much power to assign to the CEO.

Moreover, startup founders can also gain new insights on the potential benefits and costs in receiving VC funding. Furthermore, our study underscores the need for a better alignment between the incentives of various stakeholders in privately held entrepreneurial firms, particularly in their late stages. Indeed, although the interests of VCs and their investees are aligned in their early stages, their interests diverge later on, and the conflicts may be exacerbated as VCs plan to exit their involvement. Entrepreneurs should be wary of these potential conflicting interests with VCs.

Notes:

- *This post is based on the authors' paper Venture Capital, CEOs' Sources of Power, and Innovation Novelty at Different Life Stages of a New Venture, Organization Science 27(2):336-353.*
- *The post gives the views of its authors, not the position of LSE Business Review or the London School of Economics.*
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