KAUFFMAN

The Foundation of Entrepreneurship

KAUFFMAN DISSERTATION EXECUTIVE SUMMARY

Part of the Ewing Marion Kauffman Foundation's Emerging Scholars initiative, the Kauffman Dissertation Fellowship Program recognizes exceptional doctoral students and their universities. The annual program awards up to fifteen Dissertation Fellowship grants of $20,000 each to Ph.D., D.B.A., or other doctoral students at accredited U.S. universities to support dissertations in the area of entrepreneurship.

Since its establishment in 2002, this program has helped to launch world-class scholars into the exciting and emerging field of entrepreneurship research, thus laying a foundation for future scientific advancement. The findings generated by this effort will be translated into knowledge with immediate application for policymakers, educators, service providers, and entrepreneurs as well as high-quality academic research.

Kauffman Dissertation Fellowship Program KDFP Kauffman Dissertation Fellowship Program KDFP

www.kauffman.org/kdfp

Boston College

The Wallace E. Carroll Graduate School of Management

Department of Organization Studies

PITCHING TRUSTWORTHINESS:

CUES FOR TRUST IN EARLY-STAGE INVESTMENT DECISION-MAKING

a dissertation

by

LAKSHMI BALACHANDRA

submitted in partial fulfillment of the requirements

for the degree of

Doctor of Philosophy in Management

August, 2011

PITCHING TRUSTWORTHINESS:
CUES FOR TRUST IN EARLY-STAGE INVESTMENT DECISION-MAKING

Lakshmi Balachandra

Submitted to the Carroll School of Management on August 2, 2011 in partial fulfillment of the requirements for the degree of Doctor of Philosophy

ABSTRACT:

Most studies examining how early-stage investors determine in which entrepreneurs they will invest focus primarily on financial or objective factors of the business: market potential, return on investment, economic aspects of the business model without accounting for the interpersonal analysis – whether to trust the entrepreneur with time, money, and a long-term relationship. I used a sample of 101 videos of entrepreneurs pitching to a network of angel investors to determine the relationship between observed cues during the pitch and trust, and interest in investing. I identify specific cues that lead to the determination of trust in the entrepreneur during the pitch.

This research was funded in part by the Ewing Marion Kauffman Foundation. The contents of this publication are solely the responsibility of Lakshmi Balachandra.

EXECUTIVE SUMMARY:

Most examinations of early-stage investing – venture capital and angel investors who invest in start-up companies with little operating history – concentrate primarily on a structured set of economic criteria like market size, the company's past financials or future projections. These general models that early-stage investors use in making their investment decisions articulate the process as a series of risk assessments over time due to the long-term nature of these investment commitments. This approach, widespread though it is, fails to consider that an investment in an early-stage company is a decision to commit to a business idea and, just as importantly, to an entrepreneur who will lead the business idea. Though there is a substantial body of research on the role that trust plays between individuals in business decisions across a range of long-term relational contexts, there is little understanding of how early-stage investors consider the trustworthiness of an entrepreneur in their investment analysis. While research has discussed that the interpersonal evaluation of the entrepreneur is a component of the early-stage investor's investment process, this research has been limited to identifying the importance of conducting an in-person meeting with the entrepreneur to analyze the ability of the management team based on the entrepreneur's pitch or presentation. This in-person evaluation of the entrepreneur's ability directly relates to the economic analysis of the overall business, as the early-stage investor is considering how well suited the entrepreneur is to lead, grow and develop the company for financial success.

But, investment in an early-stage company and in the entrepreneur who will lead the venture is not merely a consideration of the economic potential – investment is a major commitment as early-stage investors spend many personal hours working with the

company once they have invested in it. Noted angel investor Wayne Huizenga (founder of Waste Management, Blockbuster, AutoNation) has said, "*I don't want to be just a voice on the phone. I have to get to know these guys face-to-face and develop a sincere relationship. That way, if we run into problems in a deal, it doesn't get adversarial. We trust each other and have the confidence we can work things out.*" Given this perspective, the research that states investors are examining merely the ability of an entrepreneur to evaluate the economic success of the business is incomplete. I chose to focus on the long-term relational aspect of early-stage investing, which led to my first research question: How does the assessment of an entrepreneur's trustworthiness impact an early-stage investor's interest in investing? For example, will entrepreneurs with economically viable/ sound business models be considered for investment even if they seem untrustworthy?

Trust has been defined as a condition where "the willingness of a party to be vulnerable to the actions of another party based on the expectation that the other will perform a particular action important to the trustor, irrespective of the ability to monitor and control that other party" (Mayer, Davis, & Schoorman, 1995: p. 712). Early-stage investors enter such a relationship with an entrepreneur once they decide to invest in the company; investors must determine if the entrepreneur is trustworthy or not before they invest, which requires an interpersonal analysis. Thus, investors are making personality related assessments about the entrepreneur when they observe the business pitch that is a key component of their decision-making process, though they may not articulate it as such. Instead, these overall assessments of the entrepreneur are stated after the fact, given qualities such as "likeability" or "coachability" when evaluating the entrepreneurs that successfully achieve funding versus those that do not. Examining what investors observe that leads them to make such judgments provides a new perspective on the specific behaviors or cues during the entrepreneurs' pitches that increase trust and perhaps, an interest in investing. Early-stage investors will often observe an entrepreneur's pitch and make their initial interest in investing assessments based on their perceptions during the pitch. Therefore, there may be information presented by the entrepreneur, in some cases inadvertently, that influences the investor to want to develop a long-term relationship with the entrepreneur, or in other words, to perceive the entrepreneur as trustworthy. I examined this hypothesis with my second research question: To what extent do behaviors and cues presented by the entrepreneur influence the investor to trust them and decide to invest in them, as opposed to economic aspects of the business?

To test these ideas, for my dissertation, I used real investment decision data that included early-stage investors' ratings of interest of investment in the company immediately following an entrepreneurs' pitch to them from an established investor group angel investor network. This data included 101 videos of entrepreneurs pitching to the angels, as well as demographic data on the investors and the entrepreneurs. This data from actual investors and their resulting decisions provide a unique window into the relationships between cues observed during the entrepreneur's pitch, trustworthiness assessments, economic factors and overall interest in investing. Of particular note was my use of angel investors as such investors decide whether or not to invest their own private capital on very young, often previously unfunded companies. The entrepreneur's pitch is the primary interpersonal component of the angel investor's decision-making process.

For this study, I worked with the largest angel investor group in the country, the Tech Coast Angels ("TCA") in California. I was invited to observe their executive meeting, and through discussions with their members, I learned of their decision-making process. The TCA is a collection of angel investors, around 60 or so, who pay dues to be members of the network. As a group, they screen or evaluate investment opportunities for potential investment and once evaluated as investment worthy, ultimately each angel decides individually if he or she would like to personally invest in the company. TCA investments range from $50K to $1million in total, and the company primarily invests in technology companies, though is not limited to doing so.

Like many early-stage investors, the TCA has a structured multi-stage process that they use to screen companies. First, several members of the group review short written applications submitted by companies seeking funding that describe the company, the team, the market and the growth plan. If the company passes this screen, the CEO/entrepreneur is invited to a screening meeting to pitch to the members. The screening meetings occur once a month and there are typically 3-4 companies that present to approximately 25-35 angel investors. The investors watch each entrepreneur's 15 minute pitch with accompanying slides and then have a five minute Q&A session. The entrepreneur then leaves the room and the angels discuss the positives and negatives of investing in the opportunity.

For this study, the angels filled out surveys immediately following the pitch where they rated the company and the entrepreneur on a variety of dimensions – the economic assessment of the company and the market as well as their opinions of the entrepreneur who presented it as well as their interest in investing in the company based on the pitch. For the study, I used 101 entrepreneur pitches to the TCA, the subsequent surveys by the 20-30 angels who observed the pitch as well as videos recordings of the entrepreneurs pitching to the group. With these data, I was able to focus on distinct trustworthiness assessments, as well as the economic analyses of the opportunity by the angels. In addition, independent raters coded the behaviors displayed by the entrepreneurs during the pitch by watching the videos of the entrepreneur pitching. Transcriptions of the pitches were also used to code the types of content from the language used by the entrepreneur during the pitch. All of these observed behaviors and language were used in regression analyses to the angel investors' trustworthy ratings as well as their ratings of whether they thought the company should be considered further for potential investment. This final rating is critical – entrepreneurs who do not receive positive ratings from the pitch will never enter due diligence, the next step in the investment process, and therefore, will never receive investment from investor members in the TCA.

The results of my research show that investors' assessment of the entrepreneur's trustworthiness following the pitch directly impacts and moderates any interest in investing that they had from evaluating the economic factors of the business. I found that, as hypothesized, the economic factors of the venture are the primary consideration for angel investors. However, the investors' evaluation of the trustworthiness of the entrepreneur directly influences the way the investors then assessed the economic factors of the business. That is, when investors found the entrepreneur to be trustworthy, they rated the economic factors as more attractive as well.

In this study, I was able to examine the precise amount of variance between angel investors' interest in investing following an entrepreneur's pitch to the interpersonal ratings of the entrepreneur to the economic ratings on the business. In doing so, I could quantify the overall impact the investors' interpersonal assessment has on the early-stage investors' overall investment decision making-process. I found that investors' assessment of trust in the entrepreneur significantly increases the early-stage investors' level of interest in investing in the business overall – by an additional 10%. Therefore, when entrepreneurs "pitch" more trustworthiness, they are 10% more likely to have investors interest in investing in their business.

My dissertation further identifies the key qualities that lead to the investors' trustworthiness evaluations of entrepreneurs. Theoretically, trustworthiness measures can be teased apart into competence and character considerations, and these delineations map nicely to the investor language of evaluation of the person discussed earlier (the competence of the entrepreneur to lead the venture to success versus the character of the entrepreneur to be someone likable, worthwhile in terms of a long-term relationship with the investor). Therefore, using the investor ratings, I separated out measures of competence from measures of coachability to determine which was more critical for the investors' trustworthiness assessments. I found that investors' character or "coachability" assessments were more important for trustworthiness ratings than the ratings of the entrepreneur's competency. Most likely, this is due to the assurance investors need that the entrepreneur will be committed to the business and that they will want to work with the entrepreneur as these investments are often 4-5 years if not longer. The coachabilty of the entrepreneur is critical as this quality translates into how investors judge who the entrepreneur *is.* Assessing an entrepreneur's competency, on the other hand, encompasses the entrepreneur's experience and aptitude *at that point.* While an entrepreneur's competency is an important consideration for leading and managing a business, the assessment of an individual's competency includes skills that can be learned. Investors must, therefore, in their analysis of the entrepreneur recognize that their assessment of competency is a fluid measure as it can change over time whereas the entrepreneur's character may not.

Thus, in considering if they can trust the entrepreneur from his/her pitch, investors must believe they can make up for any lack of competency of the entrepreneur. For example, if an entrepreneur doesn't know financial accounting, a professional accountant can be hired to fill this knowledge gap. This is in stark contrast with character: there is no way for an investor to compensate for differences in character which I measured as coachability in my study. This quality is critical to the investor since if the investor invests, the investor will be working with the entrepreneur for the foreseeable future. The importance of character compared to competency was clear: The results show that the investors' ratings of character of the entrepreneur are three times more important to the investor's trustworthiness assessments of the entrepreneur than their competency ratings. This is a new and important finding for investment research: in fact, coachability was the *primary* consideration for the angel investors' assessments of trustworthiness of entrepreneurs.

As I was also interested in the specific cues that led to higher trustworthiness ratings, my study also analyzed the impact of the independent observers' video coding ratings of the behaviors by the entrepreneur during the pitch.   I found several specific cues that led to higher trustworthiness ratings – in both character and competency dimensions. I found several cues for both types of trust. In terms of the entrepreneurs' competency: one, the higher level of speaking skills (general presentation ability by the entrepreneur) and two, the greater number of social network connections of the entrepreneur led to greater assessments of trust of the entrepreneur.   Then for character, one was the way in which entrepreneurs were able to accept suggestions: this was indicative of the relative "openness" of the entrepreneur – how they reacted to receiving feedback and critique.   A second cue was the similarity of the investor with the entrepreneur in terms of their background and/expertise. Other observable similarities, like demographics, however, did not increase their trust in the entrepreneur, but this may be due in part to the sample used for this study – over 95% of the entrepreneurs as well as the investors in the sample were white males. If there had been more variation in race, nationality, or gender, similar demographics may have led to greater trust in the entrepreneur.

One cue that did relate to demographics, but not in terms of similarity, was that angel investors rated younger entrepreneurs with greater character or "coachability." This finding is not unusual, given the research on ageism and work discrimination with given negative assumptions of older versus younger workers. Angel investors may feel that they cannot "mold" older entrepreneurs, and therefore, do not anticipate that they will work well with them, so cannot trust them as much. The fourth and final cue of character was greater laughter by the entrepreneur during the pitch led to greater coachability assessments. Laughing demonstrates the relative openness of the entrepreneur and the way a future relationship might look with the investor.

Setting aside the academic significance of these questions, the answers have substantial practical implications for both investors and entrepreneurs seeking capital. Entrepreneurs should be aware of the degree to which their interpersonal qualities specifically contribute to investor interest following their pitches, in particular how these behaviors related to the ways in which an investor may find an entrepreneur trustworthy which then directly impacts how investors evaluate the economic opportunity overall. From the investor's perspective, understanding how their decisions may or may not be disproportionately attributed to non-economic factors, such as long-term relational factors like trustworthiness assessments rather than merely economic potential, can provide a valuable tool to encourage re-examination of personal biases during high-risk decision making practices in general.

Lastly, this research further clarifies the specific role of pitching for the entrepreneurs seeking funding. Early-stage investors place a premium on evaluating the company and the entrepreneur during the pitch. The importance of the long-term relational component of early-stage investing, and thus, the investor's desire for an entrepreneur to appear "coachable" as a cue for trust in the entrepreneur is not only identified but quantified in this study. The angel investors in this study are motivated like most early-stage investors; they seek economic gains, but they also want to know they can help build and nurture a business to a successful financial outcome. Understanding this for early-stage investing can be a powerful tool for entrepreneurs seeking funding.

To gain trust from the angel investors - entrepreneurs should pitch trustworthiness, and given the research findings of this study, they can.