Equities

Networking as a Barrier to Entry and the Competitive Supply of Venture Capital

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Does networking among U.S. venture-capital (VC) firms restricts entry into local VC markets, thereby improving their bargaining power over entrepreneurs? Our hypothesis was that markets with more VCs would be more difficult for new VCs to enter, in part because of the relatively greater network externalities that incumbents enjoy in such markets but also because incumbents may decline to cooperate with new entrants for fear of being excluded from the network of established firms.

We find that markets with tight networks of incumbent VCs are associated with reduced entry, even after controlling for a wide variety of other influences. We also find that this has an economically significant effect. One way for new VCs to overcome this phenomenon is by "joining the club" — that is, VCs seeking to enter a new market can establish relationships with the new market's incumbents by giving them access to deals in the entrant's home market.

Having established a link between syndication networks and reduced entry, we show that the valuations at which companies can raise VC funding depend on the extent of networking and the degree of entry that results. This is consistent with an increase in incumbents' bargaining power. While networking is no doubt motivated by efficiency considerations, its entry-reducing effects do not appear entirely accidental.

Our evidence suggests that incumbents react strategically to an increased threat of entry — such as when a fellow incumbent does business with a potential entrant elsewhere — by excluding the offending VC from their deals for a number of years.

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