The Strategic Fit between Internal Capability and External Network for New Ventures

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Abstract

External network and internal capability have always been discussed in terms of their influences to new ventures' entrepreneurial performance. However, the question that how the interaction and integration of the two influence new ventures' entrepreneurial performance still remains a blank. This paper fills the gap and discusses the strategic fit between internal capability and external network by proposing two mechanisms: "fit as moderating" and "fit as matching". "Fit as moderating" refers to the synergistic effect deriving from the interaction between internal capability and external network while "fit as matching" refers to the requirement for match in the integration process to achieve a strategic fit. We suggest that as a general rule, the absolute differences between internal capability and external network indicates a lack of fit since under such circumstances a substitutive relationship between internal capability and external network is likely to weaken and replace the synergistic effect and impairs the entrepreneurial performance. We also propose a dynamic view to the evolution of the requirement from network-oriented to capability-oriented as the new venture grows. Results of analysis of 1728 new ventures in China well support the theoretical hypotheses.

Introduction

External network and internal capability are critical to new venture growth. Scholars have proposed that external network is crucial for newly-built firm to establish trust relationship (Uzzi,1996)[1], to obtain key information (Birley,1985)[2], to seek for potential cooperative partners (Pennings and Harianto,1992)[3] and to acquire entrepreneurial resources (Aldrich,2000)[4]. Scholars also emphasized the importance of internal capability to integrate resources (Zahra et al.,2006)[5] and to choose and implement the entrepreneurial strategy (Chrisman et al.,1998)[6]. However, previous researches mainly focus on one factor and the elaboration of its independent effect to entrepreneurial performance while failing to explain how the interaction and integration of them together will influence new ventures' entrepreneurial performance. This paper aims to fill the blank and investigate deeper into the internal mechanisms of the interdependence between internal capability and external network.

In this paper, our theoretical analysis is divided into three sections. Firstly, we review the previous research about the effect of internal capability and external network and propose they both exert a positive influence on firms' entrepreneurial performance. Secondly, we analyze the interaction of internal capability and external network and propose "fit as moderating" to

illustrate the mechanism which engenders the synergistic effect. On the one hand, the value of external network is enhanced by the internal capability since the absorptive capacity to assimilate and utilize outside knowledge is largely a function of the level of prior knowledge and capability (Cohen and Levinthal,1990)[7]; on the other hand, the value of internal capability is improved by the external network since more boundary-spanning activities promote knowledge transfer (Kogut and Zander,1992)[8] which is beneficial to capability development and entrepreneurial performance. Thirdly, we analyze the integration process of internal capability and external network and propose "fit as matching" to illustrate the requirement for match to achieve a strategic fit. We also propose a dynamic view of the match requirements, which present staging features as new ventures evolve. In the first place, as a general rule, the absolute differences between internal capability and external network indicates a lack of fit since a large gap between them will block the synergistic effect and induce a substitutive relationship which impairs the entrepreneurial performance. Secondly, a high degree of match presents in a network-oriented form in the start-up period since firms' internal capability is generally not recognized by outside world at this stage due to its high level of equivocality and uncertainties in organizational routines and reliability, and a focus on network development can compensate the undervaluation of the firm's capability and assist the firm to acquire crucial resources which guarantee its survival. Thirdly, as the firm grows, however, a high degree of match changed into a capability-oriented form since by overcoming the lack of legitimacy the firm evolves its identity-based network into a calculative network (Williamson,1993)[9], the development of which relies heavily on the strong internal capability.

Discussion and Hypotheses

External Network and Internal Capability

The social capital theory has emphasized firms as social-embedded organizations and has conducted a number of researches about the influence of external network to the performance of firms (Granovetter, 1985)[10]. On the one hand, extensive external network provides the firm with abundant information (Gulati, 1999)[11], which facilitates the exploitation of market opportunities and serves as sources for competitive advantage. On the other hand, extensive external network can lower the transaction cost and uncertainties, promoting market transactions and enhancing the organizations' legitimacy (Granovetter,1985) [10]. This advantage is particularly important for new ventures who suffer from the liability of newness (Stinchombe, 1965)[12]. New ventures can not only acquire complementary resources and important market information from external network, but also build intangible resources such as reputation and legitimacy improvement (Deephouse, 2000)[13] to attenuate the institutional restraints (Park et al., 2000)[14]. Based on the above reasoning, we proposed our Hypothesis 1a:

Hypothesis 1a: External network exerts a positive influence on new ventures' entrepreneurial performance.

Resourced-based view, on the other side, emphasizes the importance of new ventures' internal capability. Previous researches suggested that entrepreneurial orientation, technological capability (Lee et al.,2001)[15] and the learning capability(Cai, 2009)[16] are sources for internal capability. On the one hand, internal capability serve as the premise to entrepreneurial opportunities exploitation and the driving forces for innovation processes and thus assisting the firm to acquire first-mover advantage. On the other hand, the internal capability of the new

ventures facilitates the learning effect, which refers to the knowledge accumulation at the early period of a firm, and thus helps overcome new ventures' inferiorities in experience and scale (Politis, 2005)[17]. Based on the above reasoning, we proposed our hypothesis 1b:

Hypothesis 1b: Internal capability exerts a positive influence on new ventures' entrepreneurial performance.

Interaction between Internal Capability and External Network

Both social capital theory and resource-based view has explained the entrepreneurial performance of new ventures through either "internal" or "external" aspects while leaving the analysis of the interaction of them still a blank. In this paper, we propose that the interaction between internal capability and external network produces a synergistic effect which adds value to the new ventures' entrepreneurial performance. We call this mechanism as "fit as moderating" in this paper according to Venkatraman (1989)[18]'s clarification about the concept of fit, which means the positive influence of the firm's external network to its entrepreneurial performance is enhanced by its internal capability.

While external network is crucial to new ventures in terms of the transactions information it provides and the transaction opportunity it brings, the value of external network is even greater by the existence of strong internal capabilities. With low-level internal capabilities, the utilization of external network is limited to transaction-level such as offering more market information, introducing more transaction opportunities and reducing transaction cost. However, besides these obvious transaction-related benefits, greater value can be created by sophisticated utilization of opportunities that embedded in the firm's network such as inter-firm learning and strategic alliances. But it should be noticed that such complicated opportunity exploitation can only be realized when the firm is equipped with strong internal capability. Cohen and Levinthal (1991)[7] proposed absorptive capacity as the capacity to assimilate external knowledge and the capability to recognize and exploit external opportunities, which is largely a function of the firm's prior knowledge and capabilities. The concept of absorptive capacity applies well in this situation to explain the additional value created by the interaction between the firm's external network and internal capability. Since the value of external network mainly derives from the focal firm's cooperation with its network members, the internal capability mainly influence such value-creation from two aspects. On the one hand, before the cooperation is established, the equipment of strong internal capability enhances the firm's sensitivity to potential opportunities embedded in its network and serve as a bargaining chip to win the focal firm a favorable position during the negotiation process. On the other hand, after the cooperation is constructed, the abundant knowledge derived from the previous capability development processes enables the firm to better absorb and assimilate the knowledge from its partners during the cooperation process. Therefore the firm's internal capability improves the value of its external network by promoting the opportunity discovery and opportunity exploitation and by enhancing the firm's position in the bargaining stage. Based on the above reasoning, we proposed our hypothesis 2:

Hypothesis 2: The relationship between external network and the entrepreneurial performance of new ventures is positively moderated by the internal capability of the new ventures.

Integration of Internal Capability and External Network

In this section we analyze the integration process of internal capability and external network and propose "fit as matching" (Venkatranman, 1989)[18] to illustrate the requirement for match between internal capability and external network to achieve a strategic fit which is beneficial for entrepreneurial performance. "Fit as matching" elaborates that the entrepreneurial performance is influenced by the degree of match between the capability and network when they are integrated. We also suggested that the requirement for match is not static and presents staging characteristics and therefore we proposed a dynamic view for the mechanism "fit as matching".

Firstly we propose that the absolute differences between the strategic attentions allocated to internal capability and external network indicating a lack of fit serve as a general rule for the requirement of match. If we make a wild assumption that resource under any circumstance is sufficient, then it will become more obvious that the interaction between capability and network engenders better synergistic effect when a firm holds a comparable level of internal capability and external network. The focal firm's performance is eroded under the combination of a superior network and a relative weak capability since the firm is vulnerable to dynamic market change. While the superiority in network can to some degree compensate the deficiency in capability, the marginal substitution rate undoubtedly decrease at a faster speed as the absolute differences between capability and network grows. Such blocking mechanism also exists when a disadvantaged network appear with an advanced firm capability. While solid capability can gradually establish the firm's reliability and develop legitimacy, the inferiority in the external network limits the firm's opportunity to benefit from outside knowledge transfer and to learn from boundary-spanning activities, which in return weakens the firm's capability development. Therefore, the absolute differences between capability and network indicate a weakening of the original synergistic effect and induce the appearance of a substitutive relationship which is detrimental to the entrepreneurial performance. Based on the above reasoning, we propose the following hypothesis 3:

Hypothesis 3: The absolute difference between internal capability and external network exerts a negative influence on the entrepreneurial performance of new ventures.

While it is the goal pursuit by every new venture to achieve such a strategic fit between internal capability and external network, the reality simply violates our fictional assumption that resource would always be sufficient, especially for new ventures. Therefore it is an imperative choice for entrepreneurs to make between internal capability and external network since resources are limited and survival urgency should be handled. While the theoretically optimal development pattern mentioned above as a balanced development of both capability and network may lead to an attractive long-term return, it may also expose the new firm to short-term fatal attack by not equipping it with proficiencies to beat its competitors. Therefore we propose in this paper that the requirement for match between internal capability and external network presents staging characteristics during the transition period experienced by a new firm from its birth to its maturity, when the general requirement for match applies.

We firstly suggested that at the start-up period of the new ventures, a high degree of match presents in a network-oriented form. When the new venture is firstly built up by combining different pieces of resources and integrating various resource-owners, the loose connection, the inexperienced cooperation among organization members and the lack of perfect and stable routines (Park and Luo, 2001)[19] put the new firm under high level of equivocality and

uncertainties which seriously weaken the firm's reliability and impede the firm to acquire trust through a market-based way. As a result, the firm's ability is difficult to be accurately conveyed due to information asymmetry. Under such circumstances, a focus on network development can alleviate the undervaluation of the firm's capability and assist the firm to acquire crucial resources which guarantee its current survival. Furthermore, by establishing extensive external network and promoting transactions based on the network, the newly-built firm gradually forms its organizational routines and the pressure of legitimacy is then relieved through the firm's accumulated transaction experience. Previous researches also support such arguments by demonstrating the important role of identity-based network (Hite, 2005)[20] which is crucial to acquire resources and lower legitimacy.

However, as the new ventures evolve from the start-up period to the early-growth period, the requirement for match between internal capability and external network presents a dynamic evolution. As new ventures grow up, the firm proves its reliability and thus acquires legitimacy through its deepening embeddedness into the market. The firm's attention also shifts from survival to growth which requires more heterogeneous resources. As a result, the identity-based network accounted a lot in the start-up period has to evolve into a more calculative market-based network, which promotes the assimilation of heterogeneous resources and facilitate the learning processes. However, instead of a spontaneous transformation, the development of such calculative network requires deliberate concentration and cultivation to the firm's internal capability by shifting its attention away from the previous focus of external network. On the one hand, the entry pass into the calculative market-based network needs a solid certification of the focal firm's internal capability which has been strictly tested in their partners' pervious tentative transaction. On the other hand, the sustainment of such market-based network needs a continuous update and growth of the firm's internal capability since partners in the market-based network chooses cooperators based on their capability rather than intimate relationship, as demonstrated in the market principle "survival for the fittest". Therefore, as the firm grows, a high degree of match will gradually be demonstrated in a capability-oriented form. Based on the above reasoning, we propose a dynamic view for the mechanism of "fit as matching", which means that the requirement for match for the integration of internal capability and external network to achieve a strategic fit presents staging characteristics, changing from network-oriented to capability-oriented as the new ventures grow. We empirically test the characteristics of such mechanisms by checking whether the value of internal capability is strengthened and the value of external network is weakened as the firms' age grows. Therefore, we propose the following hypotheses:

Hypothesis 4a: The relationship between external network and the entrepreneurial performance of new ventures is positively moderated by the firm age.

Hypothesis 4b: The relationship between internal capability and the entrepreneurial performance of new ventures is positively moderated by the firm age.

Procedures for Collecting Data

Data Selection and Sample

The data used in this paper is from the Chinese Private Business Investigation Database. This investigation targets private businesses all over China. The database includes 4098 private firms and records their development since 1978, when the Open and Reform Policy is enacted.

According to the characteristics of new ventures, they generally experience a start-up period for three to five years and it often takes eight to twelve years for new ventures to get over survival problem and acquire stable growth. Therefore we select those firms whose age is below eight as our sample composition. In addition, to make sure that all firms are entrepreneurship, we exclude those private firms which evolved from public sectors. Finally, we get a sample of 1728 new ventures and their age characteristics are described as following.

Table 1: The distribution of firm age

Firm Age	one-year	two-year	three-year	four-year	five-year	six-year	seven-year	eight-year
Number	228	194	237	255	233	214	199	168
percentage	13.19%	11.23%	13.72%	14.76%	13.48%	12.38%	11.52%	9.72%

Variable Measurement

1) Dependent variable

Our dependent variable is entrepreneurial performance. The most common indicators for entrepreneurial performance in researches are: the number of employees, the sales revenues and the market share (Gilbert et al., 2006)[21]. In this paper we use the principal analysis method and extract a principal factor from employee growth, sales revenue and profitability as a measurement of entrepreneurial performance.

2) Independent variable

Our independent variable includes the new ventures' internal capability (Inter-) and external network (Exter-).We measure these two variables through a behavior perspective, which is the time devoted by entrepreneurs in each aspect. The indirect measurement is based on the following reasons: firstly, the overall measurement of the firm's internal capability and external network is absent in current research; secondly, according to current research, entrepreneur's behavior characteristics is an important decision base for external investor and a decisive factor of the entrepreneurship's success; thirdly, entrepreneur's behavior characteristics influence the exploitation of entrepreneurial opportunities and resource mobility and hence is the most important decisive factor to entrepreneurial growth.

3) Control Variable:

In addition, we select four sets of control variables: individual level, firm-level, industry level and institutional level. In the individual level, we select entrepreneurs' education background, gender, age, ex-government experience and ex-firm experience. In the firm level, we select firm age, firm size and the asset/debt ratio. In the industry level, we set a dummy variable for ten industries. In the institutional level, we use the local marketization index (Fan et al., 2010) to control institutional environment. We omit the result for control variables and the discussions in the abstract for space limitation.

Results

Descriptive Analysis

The means, standard errors and correlation coefficients among all variables are reflected in the following.

Table 2: The descriptive analysis and correlations

	Mean	Sd	Perform	Exter	Inter	Educa	Gender	EAge	ExGov	ExFirm	FAge	FSize	Ratio
Exter	0.160	0.086	0.201**	1									
Inter	0.349	0.112	0.322**	-0.222**	1								
Educa	3.939	1.171	0.194**	0.115**	0.021	1							
Gender	0.809	0.393	0.139**	0.045	0.062*	0.058*	1						
EAge	3.749	0.192	0.071**	-0.099**	0.147**	-0.132**	0.059*	1					
ExGov	0.164	0.371	0.048**	0.012	0.029	0.245**	0.011	0.131**	1				
ExFirm	0.649	0.477	0.079**	0.032	0.018	0.107**	0.026	-0.019	-0.266**	1			
FAge	4.359	2.207	0.213**	-0.012	0.290**	0.033	0.041	0.157**	0.030	0.025	1		
FSize	5.162	1.789	0.721**	0.152**	0.228**	0.222**	0.144**	0.134**	0.042	0.043	0.247**	1	
Ratio	0.254	1.614	0.119**	0.018	0.054*	-0.055*	0.045	0.007	0.001	0.001	0.006	0.076*	1
Institute	8.451	2.031	0.213**	-0.009	0.175***	-0.023	0.018	0.004	-0.110**	0.014	0.094**	0.128**	-0.006

Legend: Table 2 presents the descriptive analysis and correlation matrix among variables.
***p<0.01;**p<0.05;*p<0.10

The variable entrepreneurial performance is a principal factor extracted from the principal analysis to the number of employees, sales revenue and profits (The accumulated variation explained is 57.43% and the Cronbach α coefficient is 0.672). The negative coefficient between internal capability and external network is in accordance with the reality that the entrepreneur's time and attention allocated between internal capability and external network are scarce resources.

Regression Analysis and Hypothesis Testing

We build our model and run regression analysis according to our data. The regression result is shown in Table 3. The null model only includes control variables. In model 1, the coefficients of external network and internal capability are significantly positive, which reflects that hypothesis 1a and hypothesis 1b is proved. In model 2, the coefficient of the interaction item of internal capability and external network is significantly positive, which shows that hypothesis 2 is empirically supported. In model 3, the coefficient of absolute differences between internal capability and external network is significantly negative, which implies that hypothesis 3a is empirically supported. In model 4, the coefficients of the interaction item between external network and firm age is significantly negative, implying that hypothesis 3b is empirically supported. In model 5, the coefficient of the interaction item between internal capability and firm age is significantly positive, which suggests that hypothesis 3c is empirically supported. The result of Model 6 shows that the empirical result demonstrates a high degree of robustness.

Table 3: The regression analysis

Variable	Null Model	Model 1	Model 2	Model 3	Model 4	Model 5	Model 6
Exter		1.544 ** (0.244)	1.672 ** (0.249)	1.971 ** (0.209)	1.687 ** (0.540)	1.545 ** (0.243)	1.467 ** (0.544)

Inter		1.389 ** (0.209)	1.323 ** (0.209)	0.808 ** (0.277)	1.390 ** (0.209)	0.839 * (0.415)	0.813 * (0.421)
Exter* Inter			4.531 ** (1.872)				
|Exter-Inter|				-1.219 ** (0.228)			
Exter*FAge					-0.033* (0.109)		-0.018* (0.111)
Inter*FAge						0.229 ** (0.082)	0.232 ** (0.084)
Educa	0.025 (0.019)	0.019 (0.020)	0.019 (0.020)	0.020 (0.020)	0.019 (0.020)	0.018 (0.020)	0.018 (0.019)
Gender	0.061 (0.051)	0.068 (0.054)	0.066 (0.054)	0.056 (0.053)	0.068 (0.054)	0.074 (0.054)	0.073 (0.054)
EAge	-0.193+ (0.110)	-0.216+ (0.117)	-0.198+ (0.117)	-0.192+ (0.115)	-0.215+ (0.117)	-0.202+ (0.117)	-0.202+ (0.117)
ExGove	0.059 (0.058)	0.061 (0.060)	0.065 (0.060)	0.061 (0.059)	0.062 (0.060)	0.059 (0.060)	0.059 (0.060)
ExFirm	0.065 (0.043)	0.047 (0.046)	0.047 (0.046)	0.045 (0.045)	0.046 (0.046)	0.039 (0.046)	0.039 (0.046)
FAge	0.032 ** (0.009)	0.019 * (0.009)	0.019 * (0.009)	0.019 * (0.009)	0.019 * (0.009)	0.021 * (0.009)	0.021 * (0.009)
FSize	0.366 ** (0.012)	0.342 ** (0.013)	0.342 ** (0.013)	0.333 ** (0.013)	0.342 ** (0.012)	0.340 ** (0.013)	0.340 ** (0.013)
Ratio	0.038 ** (0.011)	0.032 ** (0.012)	0.031 ** (0.012)	0.029 ** (0.012)	0.032 ** (0.012)	0.033 ** (0.012)	0.033 ** (0.012)
Institute	0.058 ** (0.010)	0.053 ** (0.011)	0.055 ** (0.011)	0.055 ** (0.011)	0.053 ** (0.011)	0.053 ** (0.011)	0.053 ** (0.011)
Industry	Control	Control	Control	Control	Control	Control	Control
Constant	-2.159 ** (0.424)	-2.390 ** (0.457)	-2.455 ** (0.456)	-2.312 ** (0.451)	-2.415 ** (0.465)	-2.092 ** (0.467)	-2.075 ** (0.479)
Adjusted R2	0.546	0.576	0.578	0.587	0.576	0.579	0.579
R2 Change		0.030	0.002	0.011	0.000	0.003	0.003
F-value	76.52 **	67.78 **	65.28 **	67.78 **	64.65 **	65.49 **	65.58 **

Legend: table 3 presents the regression result which tests the hypothesis. ** $p<0.01$;* $p<0.05$; + $p<0.10$

Conclusion and Discussion

Our study tries to integrate current theories to explain the how the interaction and integration of new ventures' internal capability and external network will influence the entrepreneurial performance. It reveals a more comprehensive picture for the growth process of new ventures and provides practical implications for practitioners. By examining the two mechanisms, "fit as moderating" and "fit as matching", we contribute the entrepreneurship research by revealing the strategic fit between internal capability and external network.

In summary, our conclusions are: (1) internal capability and external network both exert positive performance to entrepreneurial performance; (2) the interaction between internal capability and external network engenders synergistic effect to the entrepreneurial performance; (3) the integration of internal capability and external network requires a high degree of match between them and the match requirements is dynamic as the firm evolves from start-up stage to early-growth stage. As a general rule, the absolute differences between them indicate a lack of fit. In start-up stage the high degree of match presents in a network-oriented form while in the early-growth stage the high degree of match presents in a capability-oriented form.

Despite theoretical contribution made by the paper, there exist certain limitations. Firstly, the measurement of external network and internal capability is subject to further perfection. Due to our comparatively macro theoretical perspective, we cannot measure the internal capability and external network from more specific ways such as the network provided by intermediaries, alliances and institutions and the innovation capability, managerial capability. Further research can refine an advanced measurement and elaborate how different capability and network influences the performance. Secondly, instead using longitude data, we use cross-section data which includes firms at different ages to analyze the dynamic "fit as matching" mechanism. Further research can go deeper to analyze the path-dependent characteristics and better explain the formation mechanism of the strategic fit between internal capability and external network.

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