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The Reputation Factor in Startup Companies: A Literature Review

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Abstract.

The paper analyzes the concept of reputation with particular reference to startup companies. The definition of 'reputation' that has inspired this work is that of a judgement of reliability expressed by a community about a social player based on the behaviour of that player over time. The peculiarity of this judgement is that only one or some of the members of the community have had direct knowledge of the player and their actions, and it is on this experience that they have based their personal judgements of value.

The authors carried out a literature review in order to analyze the constituent factors of reputation. What emerges is that the reputational issue is configured with marked peculiarities in startups, in particular in the pre-revenue phase, when the startup has not yet matured its history. The reputation of the pre-revenue startup, in fact, since it cannot be the product of its activity, is the product of the activity and the behaviour of the founder and, more generally, of his team; in other words, the reputation of the latter becomes the reputation of the startup. Furthermore, it is a fundamental competitive lever for the startup, as it affects the ability to raise funds.

Effective reputation management, therefore, cannot ignore the consideration of the life phase of the company and the nature of the subjects to which the reputational factors refer.

Keywords: reputation; startup companies; venture capitalists; business angels.

1. Introduction

The definition of 'reputation' that has inspired this work is that of a judgement of reliability expressed by a community about a social player based on the behaviour of that player over time[1]. The peculiarity of this judgement is that only one or some of the members of the community have had direct knowledge of the player and their actions, and it is on this experience that they have based their personal judgements of value. Yet, following said individual appreciations, a common feeling arises in the whole community, from which expectations and consequent behaviours depend (Fombrun,

[1] There are many definitions of 'reputation'. For a broad review, see: Dowling, 2016.

1996; Ferguson et al., 2000; Chun, 2005; Highhouse et al., 2009; van der Merwe & Puth, 2014).

Therefore, reputation has a public dimension and a development in time, and implies the notions of experience, direct or mediated by the experience of others, and relationship.

Since reputation is a relational concept (Roberts & Dowling, 2002), there is a need to accurately define the players with whom the relationship is established (Zerwas, 2016). Studying the reputation of a company means to identify the category of stakeholders in which the company's reputation is settled (Gotsi & Wilson, 2001; Bromley, 2002; Eccles et al., 2007; van der Merwe, 2010; Burke & Graeme, 2011)[2].We might say that reputation is a 'hidden asset' of the company (Tadelis, 1999; Miles & Covin, 2000; Miles & Covin, 2002; Mahon, 2002; Branco & Rodriguez, 2006) incorporated into its stakeholders and, as such, only partly controllable by the company (Balmer & Gray, 1999). So, not surprisingly, some scholars argue that, for a company, we should more properly speak of multiple reputations rather than a single reputation (Dowling, 2001; Mitnick & Mahon, 2007; Dowling, 2016). These authors selected some of the parameters available for each category of stakeholders and defined them as more worthwhile, in their opinion, since their weigh is prevalent with respect to the others, as a function of the interests involved. For example, the human factor and the economic-financial performance are likely to weigh more than other factors for investors, rather than for a generic customer.

The enterprise stakeholder, who is the preferable focus of this work, is the investor, who plays a prominent role in the entire life cycle of the company, since its birth or since the very first steps of the startup. But we should clarify something before we continue. Reputation plays a crucial role throughout the life of a company. Whenever there are information asymmetries, reputation acts as a factor that reduces uncertainty (Kollock, 1994; Shane & Cable, 2002; Bültel, 2011; Zerwas, 2016). However, the source and weight of reputation changes in the different stages of the life of an enterprise, particularly between the very first steps and subsequent stages. It should be preliminarily pointed out that, as we will see in a while, during the embryonic stages of a startup, when there are no significant historical data, the properties that characterize the notion of 'reputation' must necessarily and exclusively be referred to the founder and his team. It is their reputation that extends to the new entrepreneurial project and that can help fuel the investors' expectations. When the company will be consolidated and will have built its own history, primarily in terms of economic and financial results, the reputation of the management team, which – at the beginning of the project – factually coincided with corporate reputation, it will move back from its hegemonic position to become one of the many drivers that synergistically contribute to form corporate reputation.

[2] Fombrun defined reputation as "… the net perceptions of a company's ability to meet the expectations of all its stakeholders…" (Fombrun, 1996).

2. The reputation factor: a review of the literature

What are the properties of the actor, be it a natural person or a business entity, that investors mostly appreciate, that is, the characteristics that give substance to reputation?

The literature indicates *enthusiasm* and *reliability* as the most appreciated individual characteristics of the founder – and, more generally, of the individual components of the management team – among investors (Van Osnabrugge & Robinson, 2000), but also *motivation* (Robinson, 1987; Eisele et al., 2004), *commitment* (Bachher & Guild, 1996; Silva, 2004; Kollmann & Kuckertz, 2010), *resoluteness* and *persistence* (MacMillan et al., 1985; Bachher & Guild, 1996; Brettel, 2002; Mishra, 2004; Eisele et al., 2004; Black et al., 2010), and the ability to assess and mitigate risk (MacMillan et al., 1985; Mishra, 2004).

As one may expect, experience is a parameter of primary importance, both from a technical – that is, connected with the reference sector (MacMillan et al., 1985; Dixon, 1991; Muzyka et al., 1996; Bachher & Guild, 1996; Shrader et al., 1997; Shepherd, 1999a; Shepherd, 1999b; Shepherd et al., 2000; Zacharakis & Meyer, 2000; Brettel, 2002; Mishra, 2004; Eisele et al., 2004; Franke et al., 2008; Miloud et al., 2012), managerial (Black et al., 2010; Streletzki & Schulte, 2013;), and entrepreneurial standpoint (Hall & Hofer, 1993; Streltzki & Schulte, 2013). The same is true for the founder's leadership skills (MacMillanet et al., 1985; Muzyka et al., 1996; Mishra, 2004; Franke et al., 2008; Petty & Gruber, 2011).

The consideration of the individual qualities mentioned above adds up to the characteristics of the team intended as a unit (MacMillan et al., 1985; Hill & Power, 2002; Miloud et al., 2012). The most appreciated qualities are a balanced composition (Goslin & Barge, 1986; Robinson, 1987; Rea, 1989; Dixon, 1991; Bachher & Guild, 1996; Eisele et al., 2004; Mishra, 2004), a heterogeneous level of training, expertise and experience of the members (Franke et al., 2008; Streletzki & Schulte, 2013), as well as an average age of 35-45 years, which suggest the achievement of the necessary skills for an effective leadership of the production unit (Franke et al., 2008).

The considerations developed above should be supplemented with further reflections when the enterprise becomes mature, thus building its own history and acquiring a more marked identity. Then the company begins to develop its own reputation, which reabsorbs the reputation of the management team, while no longer coinciding with the latter. As the complexity of the enterprise phenomenon increases, the number and variety of the factors to which the reputation of established companies can be traced also increases and goes well beyond the personal qualities recognized at the top of the business. This is clearly shown in the studies of Fombrun and Gardberg who, in systematizing the matter, felt the need to classify the variables that define corporate reputation into multiple classes, initially six (Fombrun & Gardberg, 2000) and later seven in a subsequent work (Fombrun et al., 2015). Referring to the latter study, the dimensions considered concern: the quality of the offer and its brand; the capacity of innovation; the quality of human resources and of the working environment; the governance, particularly referring to transparency and the ethical dimension; citizenship, intended as a propensity to sustainability and to the assumption of social accountability; the presence of a strong and effective leadership, capable of defining a clear vision; and the economic-financial performance achieved (Fombrun et al., 2015). Recently, scholars have added additional factors that contribute to a good reputation: customer satisfaction (Bontis et al., 2007), the gender composition of the board of directors (Bear et al., 2010), the habit and familiarity stakeholders have with the company (McCorkindale, 2008), investments in philanthropic activities and, more generally, social activities, i.e. activities of corporate citizenship (Gardberg & Fombrun, 2006). Good reputation, therefore, consists of a generalized and settled perception in stakeholders of a widespread and multifaceted quality that permeates all the dimensions of a company's activities (Highhouse et al., 2009; van der Merwe & Puth, 2014).

3. Reputational factors in startup

In order to understand the role of reputation in startup, we should first briefly recall the life cycle of a startup, to highlight the peculiarities that characterise their development process.

The enterprise phenomenon undergoes extremely significant changes throughout its life span both as regards the constituents of the phenomenon itself and the consequent information and communication dimension, more specifically the structure of capital and corporate governance; operational processes and the consequent generation of revenues and the production of income; the risk profile; available information and market disclosures. Changes in the profiles recalled are particularly evident in the transition from a startup to an established company, but perhaps even more in the early life stages of the enterprise, particularly in the transition from a development stage to another in the startup's life cycle, namely from the *seed stage*, to *early stage*, *later stage* and *exit stage*[3].

During the initial stage of startup life cycle – the *seed* stage – there is only an entrepreneurial idea that is taking form but has not yet been converted into a production and sales process of a good or service. The activity is not yet fully structured and often the management team is also in the process of being defined. The enterprise identity is in the process of being created, as well as its business model (Reinfeld, 2018). There are no revenues yet, because the product/service is still being planned, designed or, at the latest, tried for the first time (experimentation level), so the startup is in the so-called 'pre-revenue' stage. There is maximum uncertainty, and the investment is still at risk, as proved by the average mortality rate of startups, the highest in this stage of life cycle of an enterprise (Romanelli, 1989; D'Avino et al., 2015).

Financial resources are generally provided by the founder or by his family and friends. There is also the possibility of accessing another innovative source of financing: equity crowdfunding (Miller et al., 2019). As the startup proceeds, the investment is also likely to arouse the interest of 'business angels' (Roberts, 1991;

[3] The startup life cycle can be divided into phases that are partially different from those called up in the text; see: Roberts, 1991, p. 4; Sohl, 2003, p. 11; Le Merle & Le Merle, 2015 p. 5; Dharish et al., 2020, p. 6; Jeong et al., 2020, pp. 3-4.

Freear et al., 2002; Sohl, 2003; Morrissette, 2007; OECD, 2011; Giaquinto & Bruscato Bortoluzzo, 2020).

In the *early* stage (with its various rounds), the realization of the product or the provision of the service begins. Generally, a prototype is developed, and its commercial validity is tested with the first sales and, with them, the first revenues. However, the financial situation generally is negative. Enterprise identity is gradually defined, as well as the business model. The start of production is now complete, as is the definition of the management team. The startup gradually builds up its history, although still short, but the business still needs to be launched and developed. The level of risk is a bit lower but remains high. The startup may become an interesting entity, not only for business angels, but also for venture capitalists (Tiebjee & Bruno, 1984; Roberts, 1991; Hellmann & Puri, 2002; Hsu, 2004).

The following stage is the *later* stage, when the startup and its business model have been defined, and the entity can work to conquer the market and strengthen its positioning. The turnover starts to grow, economic results improve, operations start to generate positive net cash flows. If economic results do not improve significantly, a change in the offer or a deeper revision of the business idea may become necessary. If the virtuous path has started, risk decreases. The startup can use new sources of financing to support its growth process. The typical funders at this stage are not only venture capitalists, but more generally various private equity operators (AIFI, 2004; Gervasoni & Sattin, 2008; Bentivogli et al., 2009; Damodaran, 2012).

As profitability improves and the position of the startup in the market strengthens – and the value of the startup increases –, the *exit* stage becomes more attractive. The exit strategy may take different directions: an Initial Public Offering (IPO), which leads to the listing of the company on the stock exchange (Gompers & Lerner, 2001), or a sale of shares to another, usually larger, company. Or shares may be purchased by the founders themselves, those who started the business, as outgoing investors.

The above considerations suggest that the theme of reputation is characterised by marked peculiarities when referred to startups, and particularly to their pre-revenue stage, when significant activities and results, on which the reputation of the enterprise and the expectations of its backers should be based, are scarce. Since reputation cannot be the product of the startup activity, it will be the product of the activity and behaviour of its founder and, more generally, of its team. In other words, the startup's reputation coincides with the reputation of its founder and management team (Chatsios et al., 2016). Reputation, therefore, is a crucial element of judgment for the investor who must make decisions on whether to support the entrepreneurial initiative, which is considered worthy of trust also based on the reputation of its management team (Morrissette, 2007; Cusumano, 2013).

4. Conclusions

Reputation has a significant impact on going concern during the entire life cycle of the company. However, its source and its weight change as a function of the stage of enterprise life cycle. This cannot be ignored in setting up the most suitable valuation methods to determine the value of a growing company.

The investors are proved to be particularly sensitive to reputation factors in all the phases of a company's life cycle, whatever the industry and the geographical area in which the company operates (Kelley & Thams, 2019), as they recognize the capacity of reputation to reduce uncertainties and the help it can give in predicting the possible future behaviour of the player (entrepreneur, management team, company). However, the contribution of reputation in estimating the value of an enterprise is particularly valuable in the early stages of its life.

When an enterprise has no history, it is the history of the founder and that of the management team that takes on special significance; their history originates their reputation, and their reputation becomes the startup's reputation on which investors will base their expectations.

As the startup grows, operates in the markets and produces its own results, that is to say it is building its history, the reputation of the startup takes shape, going beyond the reputation of its founder and, more generally, of its management team.

In parallel, the opportunity of anchoring expectations and projections to realized economic and financial values will redefine the key elements of the reputation. The reputation takes on different connotations, expands and diversifies in content, to include a multiplicity of factors, e.g. the quality of the offer and its brand, the quality of human resources and of the working environment, the capacity of innovation, the governance (Fombrun et al., 2015). Effective reputation management, therefore, requires an awareness of the reputation evolution during the life cycle of the firm.

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