

## The impact of social capital with customers on start-ups' performance and growth

Brinja Meiseberg

Institute of Strategic Management  
Westfälische Wilhelms-Universität Münster, Germany

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### Keywords

Social Capital; Customer Relationships; Entrepreneurial Characteristics; Start-up Performance

### Abstract

*Across developed and developing economies, research has provided ample evidence for the importance of entrepreneurs' social capital for venture creation. Scholars have particularly focused on relationships with investors, suppliers, administrative boards, and on interfirm networks. However, anecdotal evidence illustrates that social capital with customers can be most decisive for successful start-up, particularly in high-quality service contexts. The phenomenon has been observed in various settings, including advertising, software development, financial, tax and legal services: Entrepreneurs that are able to take (parts of) their former employers' customer base with them into independence strongly enhance their prospects in the marketplace, as obviously, an established customer base instantly generates sales, word-of-mouth, and referrals. Yet so far, there is no systematic research investigating the actual prevalence and performance effects of such "customer transfer" in everyday practice. Based on longitudinal data from 450 German start-ups in franchised services, we explore the role of social capital with customers for start-up. The results document a strong linkage between customer capital and start-up performance. Entrepreneurs' subsequent efforts for managing customer relationships successfully (concerning retention, cross- and upselling, referrals) moderate the linkage. However, contrary to our expectations, performance advantages are rather short-lived. Yet, initial customer capital still pays off in terms of opportunities for faster expansion.*

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## 1 Introduction

*"Just as for a child, the conditions under which an organization is born and the course of its development in infancy have important consequences for its later life"*  
(Boeker, 1989: 490)

Across developed and developing economies, the entrepreneurship literature has long assumed that entrepreneurial success can be attributed to some set of demographic factors, personality traits, or psychological variables that would be beneficial to achieving business performance (Borras, Ernst and Haggard, 2000; De Carolis and Saporito, 2006; Fischer and Reuber, 2000; Low and Abrahamson, 1997). Yet as contradictory research results show, the advantageousness of many characteristics is context-dependent. Any set of factors varies in its advantageousness depending on the specific business environment. A newer stream of research emphasises the importance of entrepreneurs' (social) networks, and the *social capital* inherent in them. Social capital is "the sum of the actual and potential resources embedded within, available through, and derived from the network of relationships possessed by an individual" (Nahapiet and Ghoshal, 1998: 243) that create "entrepreneurial opportunities for certain players and not for others" (Burt, 1992: 7). Yet, not all well-connected, aspiring entrepreneurs are able to successfully launch a business either, as relationships differ in their usefulness for reaching

performance ends (Combs and Ketchen, 1999).

Insights into factors driving start-up success independent from specific contextual conditions are scarce. However, of all the social capital that new firms can have in terms of relationships with other actors, *customer relationships* are the most central to their profit generating purpose (Gupta, Lehman, and Stuart, 2004; Srivastava, Shervani, and Fahey, 1998; Yli-Renko and Janakiraman, 2008). In this study, we explore effects of social capital with customers, “customer capital”, on start-up success.

In customer relationships, entrepreneurs build up reputation (Reuber and Fischer, 2005). The value of a good reputation and social ties with customers is twofold. First, a good reputation motivates customers to continue a relationship with a firm. Second, social ties transfer expectations about people’s behavior from a prior social setting to a new business transaction (Shane and Cable, 2002; Uzzi, 1996). Then, entrepreneurs may be able to use their customer relationships – those that they have built in a previous occupation – as a strategic asset for start-up. Those start-ups who can transfer customers from their previous into their subsequent occupation have a starting advantage, since an established customer base instantly provides sales and referrals. In the following, “social capital transfer” describes the start-up’s ability to transfer social capital in terms of customer relationships into the franchise arrangement.

For studying effects of customer capital, we focus on the franchising context, as first, there is little research into what makes franchisees successful, and second, due to the franchisor’s provision of support and brand name recognition, conditions for start-ups are more comparable in a sample of franchisees than for any sample of independent entrepreneurs, thus effects of customer capital should become more visible. Besides, franchising is similar to other hybrid organizations in various aspects (e.g., strategic orientations, common interest, expectation of gains, shared history, ongoing collective action), so that the approaches taken here should also be of interest to scholars studying social capital and interorganizational relationships outside the franchise arrangement.

Based on the literature on social capital and new venture performance, this study makes several contributions. First, prior studies on new firms’ relationships with customers examined primarily technology-based firms (Gopalakrishnan, Scillitoe, and Santoro, 2008; Yli-Renko and Janakiraman, 2008) and selected relationships like “key customers” (Abratt and Kelly, 2002; De Clercq and Rangarajan, 2008; Venkataraman, Van De Ven, Buckeye, and Hudson, 1990; Yli-Renko, Autio, and Sapienza, 2001a; Yli-Renko, Sapienza, and Hay, 2001b), and neither addressed transfer of social capital nor considered the franchising context. Thus, this study adds to the broader discourse on the role of customer relationships for start-up performance and development. Second, we extend research on franchisee performance, which is largely absent so far (Dant, 2008; Michael and Combs, 2008). Third, the few empirical studies on franchisee selection (Altinay and Miles, 2006; Clarkin and Swavely, 2006; Wang and Altinay, 2008; Williams, 1999) provide little evidence for how to select potentially better performing franchisees (Birley and Westhead, 1994; Jambulingam and Nevin, 1999; Saraogi, 2009). Still, identifying highly able network members is central to each chain’s prospects in the marketplace. Our results offer theoretical and managerial implications both for individual entrepreneurs organizing their start-up as well as hybrid organizations selecting network members more successfully.

The next section outlines the theoretical background and present hypotheses. Section 3 describes data and methods, section 4 reports the results. Section 5 concludes and discusses implications.

## 2 Main Approach

### 2.1. Theoretical background and hypothesis

Research has addressed reasons for individuals to pursue the exploitation of entrepreneurial opportunities in terms of starting a new venture (De Carolis and Saporito, 2006; Kaufmann, 1999; Lumpkin and Lichtenstein, 2005; Williams, 1999). Yet, little is known about factors that drive the success of these exploitation attempts. Apparently, only a small proportion of entrepreneurs have the potential for substantial wealth creation (Birley and Westhead, 1994; Cooper, Gimeno-Gascon, and Woo, 1994; Gilbert, McDougall, and Audretsch, 2006; Reynolds, 1987).

Studies have analysed performance differences among independent founders. The belief that the entrepreneurial firm is an extension of the entrepreneur has led many researchers to examine the entrepreneur's personal characteristics (Gilbert et al., 2006). A plethora of factors has been considered (e.g. Cooper et al., 1994; Davidsson and Honig, 2003; Sapienza and Grimm, 1997; Shrader and Siegel, 2007; Vanaelst, Clarysse, Wright, Lockett, Moray, and S'Jegers, 2006). Demographic studies examine characteristics like the entrepreneur's age, gender, family background, education and experience. Personality and psychological studies examine variables like the need for achievement, risk aversion, values and beliefs. Behavioural studies considered behaviour and decision-making based on managerial, manufacturing, marketing, organisational, or technical skills (Chrisman, Bauerschmidt, and Hofer, 1998; Gilbert et al., 2006; Shrader and Siegel, 2007). By examining these factors, research has demonstrated that entrepreneurs are in fact heterogeneous. Yet, results concerning the linkages between these factors and performance (in terms of sales, growth, ROI, or survival e.g.) are ambiguous (Low and Abrahamson, 1997; Newbert, 2005; Shrader and Siegel, 2007; West and Noel, 2009). Factors that lead to success in one context can lead to failure in another (Low and Abrahamson, 1997).

A newer stream of research emphasises the importance of networks, and the social capital inherent in them. Low and Abrahamson (1997: 437) point out that "entrepreneurship is a social process", where organisations emerge because critical stakeholders commit to the organisation's concept and their support is required for venture success. Researchers use the notion of social capital to refer to both the relationships that exist among individuals and the assets that are mobilised through these social relationships (Burt, 1992; Nahapiet and Ghoshal, 1998). The literature emphasises its importance as the primary link to resources necessary for firm survival and growth (Kwon and Arenius, 2010; Zahra, 2010). Social capital can enhance performance directly by providing entrepreneurs with access to information, financial capital, emotional support, legitimacy, or competitive capabilities, and can offer indirect benefits by leveraging the productivity of internal resources (Florin, Lubatkin, and Schulze, 2003; Stam and Elfring, 2008).<sup>1</sup>

Yet, as De Carolis, Litzkie and Eddleston (2009) point out, not all well-connected, aspiring entrepreneurs are able to successfully launch a business. Clearly, social capital is not universally beneficial for performance either – for example, because of investments involved in building and maintaining relationships, or since available resources are redundant or irrelevant

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<sup>1</sup> Two mechanisms explain why social ties provide access to resources under information asymmetry (Podolny, 1994). First, ties create social obligations that cause parties to behave generously towards each other (Gulati, 1995). Second, decision makers may be interested in preserving the exchange of private information, to be able to remove some ambiguity from future decisions (Burt, 1992). The first rationale offers a socialized perspective, the other is consistent with self-interest.

(Nahapiet and Ghoshal, 1998; Nasrallah, Levitt, and Glynn, 2003; Uzzi, 1996). As Adler and Kwon (2002: 26) observed, "In life we cannot expect to derive any value from social ties to actors who lack the ability to help us". Obviously, relationships differ in their usefulness for reaching entrepreneurial ends.<sup>2</sup>

Often, relationships provide only *potential* benefits (Srivastava et al., 1998) and obtainable resources – like information access, emotional support, or legitimacy – explain performance to the extent that organisations capture the economic value that they can create (Crook, Ketchen, Combs, and Todd, 2008). However, resources obtainable from relationships with customers in terms of *revenues* provide *actual* benefits to the entrepreneur (in addition to potential benefits like access to information that the entrepreneur may be able to exploit and convert into future revenues). Thus, social capital with customers is relevant for performance across multiple contexts.<sup>3</sup> Research shows that social capital in terms of customer relationships and the assets mobilised thereby, "customer capital", serves as a barrier against customer switching (Duffy, 2000; St-Onge, 1996). Reichheld (1996) identified six economic benefits of retaining customers: (1) savings on customers' acquisition or replacement costs, (2) guaranteed base profits as existing customers are likely to have a minimum spend per period, (3) growth in per-customer revenue as over time, existing customers are likely to earn more, have more varied needs and spend more, (4) reductions in relative operating costs as firms can spread costs over more customers and over a longer period, (5) free of charge referrals of new customers from existing customers, and (6) price premiums as existing customers do not usually wait for promotions before deciding to purchase, particular with new versions of products. Therby, sustaining customer relationships increases firm performance (Dawkins and Reichheld, 1990; Reichheld, 1996).

Based on these insights, some start-ups may be able to use customer relationships that they have established in another occupation as an asset for starting a new venture. Entrepreneurs who can transfer customers from the previous into their subsequent occupation have a strategic advantage, since an established customer base generates instant sales and referrals. Such customer transfer can occur as there are information asymmetries in markets. Entrepreneurs possess information about their business that others do not. Customers face risks when selecting among firms as firms vary in the ability to provide good service and may act opportunistically towards them. If the entrepreneur has met customer expectations particularly well before and has built up a good reputation, customers may choose to remain loyal to the entrepreneur's new business as well.

There is anecdotal evidence that customers in fact follow a well-reputed seller who leaves the firm and starts in or founds another. First, the first customer of SAP, the British chemical company ICI, was previously an IBM customer that had been served by a member of the SAP founders' team at IBM. Second, when the Saatchi brothers left Saatchie and Saatchi and founded M and C Saatchi in 1995, they took along top clients. Third, in 2000, UTA Telecom followed their creative advisors from Lintas to BBDO. Fourth, One (telecommunications) and

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<sup>2</sup> "A given form of social capital that is valuable in facilitating certain actions may be useless or even harmful for others" (Coleman, 1990: 302). On whether franchisees are truly "entrepreneurs", see Kaufmann and Dant (1999).

<sup>3</sup>Sveiby (1989; 1997) pioneered the inclusion of customer capital as intangible assets of firms. He classified three customer types according to their contributions to value creation. The first type improves employees' learning and ideas; the second enhances external structure through referrals to new customers or the establishment of prestige; the third enhances the internal structure through leveraging R&D or knowledge transfer.

mobilcom austria accompanied the creative directors who had served them before to new agencies. Concerning these and other examples, Marketing Director S. Mathony (Booz and Company) states, "giving up a cooperative relationship involves risks. Thus, for some customers, following a trusted seller is worthwhile" when this seller moves to another firm (Extradienst, 2009: 4). Similarly, Bolton, Katok and Ockenfels (2004) note that in the insurance industry, customers are often more loyal to the salesperson than to the company.

Scholars also emphasize the effects of adequate customer relationship management (CRM) practices on customer loyalty. Loyalty is often interpreted as actual retention, which is a cornerstone of customer relationship management (Reinartz, Krafft, and Hoyer, 2004; Wu, 2008). Boulding, Staelin, Ehret, and Johnston (2005) explain that CRM relates to firm strategy and centers on the development of appropriate (long-term) relationships with specific customers or customer groups, the acquisition of customer knowledge, and the intelligent use of data and technology, to enhance customer loyalty and organizational performance. Social capital with customers and appropriate relationship management can enhance the entrepreneur's ability to obtain (nonpublic) information by offering better timing, relevance, and quality of information, and lower information-gathering costs (Adler and Kwon, 2002; Bae and Koo, 2008; Burt, 1992; Nahapiet and Ghoshal, 1998; Podolny, 1994; Sasson and Fjeldstad, 2009; Uzzi, 1996). For example, customers can refine the start-up's knowledge about customer preferences and thereby, promote the provision of satisfactory services (Gupta and Zeithaml, 2006; Ramani and Kumar, 2008; Srinivasan, Anderson, and Ponnnavolu, 2002). Besides, loyal customers offer enhanced potential to engage in cross- and up-selling activities. Moreover, loyal customers often provide referrals, as they tend to spread word of mouth if they feel good about the relationship with a firm and believe that a firm offers economic value (Ramani and Kumar, 2008; Reichheld, 2006). Thereby, they bring in new customers. In consequence, entrepreneurs that engage in activities that help managing retention, cross- and upselling, and referrals, should benefit from customer transfer even more.

*Hypothesis 1. Customer capital transfer enhances start-up performance.*

*Hypothesis 2a. Activities to manage customer retention enhance positive effects of customer capital transfer on start-up performance.*

*Hypothesis 2b. Activities to enhance cross-selling and up-selling enhance positive effects of customer capital transfer on start-up performance.*

*Hypothesis 2c. Activities to manage customer referrals enhance positive effects of customer capital transfer on start-up performance.*

However, initial resources may predispose entrepreneurs to certain paths or equip them with unequal abilities to meet challenges, but they do not predetermine the future. Rather, the subsequent unfolding of events, including key decisions and management practices of the entrepreneur, shapes the new firm's performance (Cooper et al., 1994). Yet, reputation differences have been found to be quite stable over time, so that an entrepreneur's good reputation with customers is difficult to replicate in the short term (Fischer and Reuber, 2007; Roberts and Dowling, 2002). Hence, a good reputation with customers at start-up may bind customers over a longer period, with all the positive effects of customer retention on performance. The reputation-performance-effect may even operate in both directions (McGuire, Schneeweis, and Branch, 1990): a firm's reputation with its customers increases its performance and in turn, sound performance affects its reputation positively, which reinforces existing relationships and helps to attract additional customers. Then, social capital transfer is not just a starting advantage, but a lasting advantage.

*Hypothesis 3. Customer capital transfer enhances long-term performance.*

## 2.2 Sample, variables, and methods

### 2.2.1 Sample

The sample comprises 450 German franchisees from chains in advisory, financial, legal, health care, and education services. Services is the second largest industry in franchising in Germany (in 2011 sales, 34%). The context selected for the study possesses multiple desired characteristics, including customer motivation, uncertainty and experience properties. Fischer and Reuber (2007) argue that consumers are motivated to pay closer attention to a firm when they perceive that important outcomes depend on it. The seller's efforts are particularly important in industries that are characterized by consumer uncertainty. The sample context is characterized by uncertainty because quality differences in services may be hard to spot initially. We preferred a consequential context because risk-free exchanges are less relevant to trust development and reputation-building (Sirdeshmukh, Singh, and Sabol, 2002).<sup>4</sup> Common wisdom holds that industry experience is not essential for franchisees as the franchisor provides training and support. Yet, customer transfer may be more likely when start-ups are in the same industry as their former firm is in. A third of the sample franchisees (34%) had been active in the same line of business before system entry. 84% had stayed in the same geographical area (based on two-digit postal codes) as their previous employer. Thus, in the sample context, consumers had both the motivation and the opportunity to remain loyal to a start-up because of previously satisfactory services.<sup>5</sup>

Data collection was linked to a larger project on franchisee-rated system quality conducted annually by the German International Centre for Franchising and Cooperation. Many systems had actively encouraged their franchisees to participate in this survey for several years (systems that offer business concepts of outstanding quality to franchisees receive a "medal" and media attention). The collection method assured considerable response rates. Besides, longitudinal data from the quality survey also allowed tracking system development over time, as well as conducting stringent tests on sample representativeness and extending the analysis to include system-level control variables. At first, we contacted all chains in the chosen service sectors that had at least one franchised outlet according to the German Franchise Guide, or additional Internet searches, at the time of data collection. Mailing addresses for headquarters were mostly available from the Internet, yet contact information on new franchisees was usually not. Consequently, each company was contacted by phone to identify locations of new outlets (opened in 2008) through a systematic process. Subsequently, these outlets were contacted by phone. After presenting the survey background, respondents were asked to provide an email address to which the survey could be sent. 826 individuals agreed to receive the survey. Self-administered online questionnaires were distributed to these individuals in late 2009. The formulation of the questionnaire items emerged from a qualitative-explorative pre-study involving franchisors, franchisees, and franchisee focus groups from two systems in retailing. In four rounds of follow-up calls, non-respondents were contacted for telephone interviews. Responses arrived until March 2010. The response rate was 64%. If franchisees owned multiple outlets, they were asked to focus on their first outlet. In a second wave of data collection in late

<sup>4</sup> Fischer and Reuber (2007) further pointed out that in high-motivation contexts, a firm's individual reputation is more important to customers than the overall reputation of the category to which the firm belongs. So the start-up's reputation can count more than the franchisor's. Additionally, franchisor reputation is the same for all franchisees, so differences depend on the start-up.

<sup>5</sup> We run the analyses once with, once without those entrepreneurs that moved across a greater distance. However, we do not find significant differences in results.

2011, the same outlets that had participated in the first round were contacted. The response rate was 55%. 73 outlets were out of business, bought back, the franchisee had changed, or they had lost interest in participating in the survey. Accordingly, the analysis is based on 450 responses in each round.

We compare each system's average sample observation with the average outlet-owner computed from each system's population along the dimensions age, gender, years in business, and prior self-employment. We use previously collected data, and to obtain further information on the populations, officials in the chains were contacted. No evidence of nonresponse bias emerged.

### 2.2.2 Dependent variables

Capturing the multidimensionality of new firm performance requires objective and subjective measures to achieve triangulation (Baron and Tang, 2009; Brush and Vanderwerf, 1992; Chandler and Hanks, 1993; Stam and Elfring, 2008; Zahra, Neubaum, and El-Hagrassey, 2002). Following Zahra et al. (2002), we use the objective performance criteria of *total sales* and *growth*. Sales are the most common indicator of new venture performance (Birley and Westhead, 1994; Brush and Vanderwerf, 1992; Cooper, Woo, and Dunkelberg, 1989; Gilbert et al., 2006; Roberts and Dowling, 2002; Stam and Elfring, 2008). Although sales volume is only a short-term measure of a store's competitive strength, long-term implications suggest a strong linkage of sales and profitability (Buzzell and Gale, 1987). Amason, Shrader and Tompson (2006), Chrisman and Leslie (1989), Covin, Green and Slevin (2006), Florin et al. (2003), and Sapienza, Smith and Gannon (1988) also use sales growth, which is consistent with previous research on network forms of organisations (Lee, Lee, and Pennings, 2001; Sarkar, Echambadi, Cavusgil, and Aulakh, 2001; Singh and Mitchell, 2005; Stuart, 2000).

For measuring sales and growth, respondents filled in a series of blanks, as done in prior studies (Zahra and Bogner, 2000; Zahra et al., 2002). Brush and Vanderwerf (1992) and Chandler and Hanks (1993) established high accuracy and reliability of such founder reported performance data. Franchisees were asked for sales volume in the first business year after start-up for investigating the short-term effect of social capital transfer. For assessing potential lasting effects, a three-year time lag was chosen, in line with the literature (Homburg, Droll, and Totzek, 2008; McGee, Dowling, and Megginson, 1995; Reinartz et al., 2004; Rust, Moorman, and Dickson, 2002). For sales growth, we use the three-year compounded annual rate in line with previous studies (McGee et al., 1995; West, 2007).

Prior research recommended comparing primary and secondary data to establish validity of survey-based measures (Brush and Vanderwerf, 1992; Chandler and Hanks, 1993, McDougall and Robinson, 1990; Stam and Elfring, 2008; Zahra et al., 2002). Corroborating data on past performance for a subsample of 82 firms could be obtained from system sources. Results alleviate concerns; correlations are 0.94 for first year sales, 0.92 for growth ( $p < 0.001$ ).

Perceived performance was measured with the previously validated three-item scale used by West (2007; also, West and Noel, 2009). Although personality and aspiration levels could affect perceived performance evaluations, subjective measures have shown strong reliability and validity (Stam and Elfring, 2008). The scale's first item assessed the percentage of ideal performance being achieved in the first year after start-up (West, 2007). The other two items measured initial growth and overall performance in the first year "relative to competitors in the system who are comparable in age" (Abeele and Christiaens, 1986; Sapienza et al., 1988; West, 2007; West and Noel, 2009). Porter (1980) argued that firms are aware of competitors' activities, a position substantiated by Brush and Vanderwerf (1992). In line with West and Noel (2009) and Stam and Elfring (2008), the items are based on a 7-point agreement scale (7, "much

better" to 1, "much worse"; the first item's percentages were transformed on a 7-point scale). A composite scale was built by summing and averaging the item scores, using equal weights. Scale reliability was assessed by Cronbach's alpha. The alpha value of 0.94 was well above the lower acceptability limit of 0.60 (Hair, Anderson, Tatham, and Black, 1998). Item-to-total and inter-item correlations supported construct reliability. When factor analysed, all factor loadings were highly significant, which indicated convergent validity (Bagozzi, Yi, and Philips, 1991; Homburg et al., 2008). A substantially similar scale has been reliably used in other research on new ventures (Lumpkin and Dess, 1995).

### 2.2.3 Independent and control variables

**Social capital transfer.** We use franchisee-reported data as real time data on all customers of all start-ups was obviously unobtainable. As indicators of social capital with customers, customer retention and loyalty measures are used most often in the literature (Chang and Tseng, 2005; Duffy, 2000). Dawkins and Reichheld's (1990) seminal paper on retention suggested measuring the number of customers staying as a percentage of the original number over a specific period. Duffy (2000) assessed customer capital as the number of customers present and the annual sales per customer. Wiesel, Skiera and Villanueva (2008) proposed a model to monitor customer assets by the numbers of total, new, and lost customers, the cash flow per customer, and the retention rate. Hitt, Shimizu, Uhlenbruck and Bierman (2006) quantified „relational capital" with clients in law firms by the number of clients, average percentage value of each client's sales of total sales, and annual compensation received from each client. Based on 7-point scales, we follow the latter approach, asking franchisees for assessments of these items in reference to their transferred customers. A composite scale was built by summing and averaging the item scores, using equal weights. Scale reliability was assessed by Cronbach's alpha (0.82), item-to-total and inter-item correlations, which supported construct reliability. When factor analysed, all factor loadings were highly significant, indicating convergent validity (Bagozzi et al., 1991; Homburg et al., 2008).<sup>6</sup>

**Customer retention, cross- and up-selling, and referrals.** The variables are measured in line with Reinartz et al. (2004) (see Appendix). Cronbach's alphas of the composite scales (0.93/0.87/0.88), item-to-total and inter-item correlations supported scale reliability.

**Control variables.** We use control variables that are commonly used in entrepreneurial and franchising research (Baron and Tang, 2009; Cooper et al., 1994; Garg, Rasheed, and Priem, 2005; Jambulingam and Nevin, 1999; Kwon and Arenius, 2010; Low and Abrahamson, 1999; Wiklund and Shepherd, 2003): franchisee age and education (in years); gender (1 - male, 0 - female), prior self-employment, prior leadership position and prior industry experience (1 - yes, 0 - no); franchisee "background" in terms of the number of family members and close friends who were self-employed prior to the franchisee's start-up; system dummies; outlet size (number of employees; Yli-Renko and Janakiraman (2008); in categories of 1-3, 4-6, etc.), GDP index of the outlet's area in the first and third year of data collection (source: Statistisches Bundesamt, Federal Statistical Office), and the competitive situation (number of other outlets in the same area in those years).<sup>7</sup>

Franchisees interviewed in the pre-stage believed that the approaches taken were

<sup>6</sup> Of the sample franchisees, 31% could not transfer any customer. The situation is more complex when customers have multiple suppliers or a few customers spend disproportionately. We could not specify these issues.

<sup>7</sup> We also controlled for competition from non-system sources on a yearly basis, but results were inconclusive.



appropriate for gathering information on the study context. The study further controlled for common method bias in the self-reported variables using Harman's single factor test. The test yielded more than one factor, no factor accounted for most of the variance; thus, according to Podsakoff, MacKenzie and Lee (2003), common method bias was not an issue.

### 2.3 Methods

**Cross sectional data.** Initial investigation revealed that the dependent variables were not normally distributed. Following Chrisman, Chua and Steier (2002) and Kennedy (1979), we used natural logarithms to examine the relationship between social capital transfer and performance (H1). Following Shane, Shankar and Aravindakshan (2006), nonlog variables were used for robustness checks: the regression results did not show substantive differences from the regression with log variables. For testing the implications of customer relationship management on the linkage postulated in H1, we estimated moderated regressions (Aiken and West, 1991; Baron and Kenny, 1986). Following the methodology by Sharma, Durand and Gur-Arie (1981), the interaction terms used in the regressions were the product terms of the mean-adjusted scales for customer transfer and the customer relationship management variables. The analysis controlled for absence of multicollinearity using Variance Inflation Factors (all below three), and for normal distribution of disturbances with Kolmogorov-Smirnov-Tests.

**Balanced panel data.** Following Roberts and Dowling (2002), a first-order autoregressive model was used to capture the intertemporal effects of the regressors on sales performance (H2):

$$\begin{aligned} PERFORMANCE_{it} = & a_0 + a_1 * SCTRANSFER_{it-1} + a_2 * RETENTION_{it-1} + a_3 * CROSS\_UP_{it-1} \\ & + a_4 * REFERRAL_{it-1} + a_5 * SCTRANSFER_{it-1} * RETENTION_{it-1} + a_6 * SCTRANSFER_{it-1} * \\ & CROSS\_UP_{it-1} + a_7 * SCTRANSFER_{it-1} * REFERRAL_{it-1} + a_9 * PERFORMANCE_{it-1} + e_{it} \end{aligned}$$

where  $PERFORMANCE_{it}$  ( $PERFORMANCE_{it-1}$ ) is third (first) year performance of firm  $i$ .<sup>8</sup>

A fundamental assumption of regression analysis is that the independent variables are uncorrelated with the disturbance term. Otherwise, OLS coefficients can be biased. Here, we expected that the independent variables that influenced first year performance influenced third year performance as well, and first year performance was included as a regressor variable. So, potential simultaneity issues arise. The standard approach in cases where a regressor variable is correlated with the residuals is to estimate the equation using instrumental variables regression (Maddala, 2001). Thus, we used two-stage least squares (2SLS). Prior industry experience, prior leadership position and prior self-employment were used as instrumental variables. The variables fulfilled the criteria of relevance and exogeneity (Maddala, 2001) since they influenced first year performance (Models 0-1), and did not influence third year performance directly according to correlations and auxiliary regressions, but only indirectly via first year performance. This may be intuitive as these "experience variables" provide new franchisees with a know-how advantage at start-up, yet their advantage erodes as other new franchisees acquire the same skills over time. OLS and 2SLS results concur. A Hausman test indicates that 2SLS results would be more reliable. Thus, we report 2SLS results. We used White period estimates as a coefficient covariance method so that standard errors were robust to serial correlation (Arellano, 1987; White, 1980).<sup>9</sup>

<sup>8</sup>*SCTRANSFER* refers to the social capital transfer variable. Higher initial performance allows investments in additional marketing or customer acquisition and binding activities e.g., which in turn may affect future performance.

<sup>9</sup>We also estimate a random effects model which, in line with the results presented here, also documents the importance of customer transfer and CRM activities for start-up performance, but not for performance over time.

## 2.4 Results

Table 1 displays the coefficient estimates of the OLS and 2SLS Models. Table 2 presents the variables' statistics and correlations. H1 is supported; social capital transfer enhances both sales and perceived performance (Models 1, 2). For sales performance, H2a-care supported as well; social capital transfer enhances performance particularly if entrepreneurs engaged in activities to retain customers, enhance cross- and up-selling, and manage referrals, if so to different extents (Model 1). Apparently, cross- and upselling activities pay off more than customer retention, and both are more effective than referral management. H3 is not supported: although franchisee performance is path-dependent, so that high first year sales induce high later sales (here, in  $t = 3$ ), social capital transfer and interaction effects at start-up do not correspond to high performance in later years (Model 4). In fact, growth rates for start-ups who realised social capital transfer were lower than for others who did not have this starting advantage (Model 3). Thus, over time, start-ups who could not transfer social capital catch up with those who could; after three years, sales performance is about to even out among the two groups. To illustrate this result, the data shows that in the first year, franchisees who transferred less social capital than the average franchisee had a mean sales disadvantage of 14% compared with those whose transfer was average or more. After three years, they caught up, reaching 94% of the other group's sales performance. Thereby, social capital transfer can strongly influence the start-up's ability to generate a positive margin. In addition, there the correlation between customer transfer and a variable indicating whether a franchisee owns multiple outlets already in their third year after start-up, is substantial (0.34,  $p < 0.001$ ). We cautiously conclude that initially better performing franchisees tend to have more outlets later and thus have better opportunities of realizing expansion plans (**Please see Table 1 and 2 under appendix**)

## 3 Discussion

Across developed and developing economies, the scholarly discourse on start-up performance has long proclaimed that start-ups differ in their potential for wealth creation and that entrepreneurial success can be attributed to some set of demographic factors, personality traits, or psychological variables that holds across different contexts (De Carolis and Saporito, 2006; Low and Abrahamson, 1997). But as contradictory research results show, the performance effects of many entrepreneurial characteristics turn out to be strongly context-dependent. Accordingly, we focus on performance effects of start-ups' customer capital as a success driver that should be more universally applicable. The idea is that start-ups can use customer relationships that they had established in another occupation, prior to system entry, as an asset for starting as a franchisee: transferring loyal customers from a previous occupation into the franchise arrangement then provides instant advantages like sales and referrals.

The franchise context is particularly useful for analysing the impact of social capital transfer as (nearly) "all other things are equal": the conditions under which prospective franchisees start are much more homogeneous – as regards the business concept, product portfolio, initial investments, franchisor support etc. – than the range of conditions under which independent business owners start. Based on panel data from 450 German franchise outlets, the empirical results show that customer transfer in fact enhanced initial performance; even more so, if adequate CRM activities were in place. Cross- and upselling efforts prove particularly beneficial to performance, more than activities targeted at customer retention or referrals. Yet, the benefits of customer transfer seem to wear off quickly over time: after three years, 95% of first year performance differences among customer-transferring and non-transferring

franchisees have evened out. Thus, social capital transfer offers a strong short-term, but not a strong lasting, advantage.

Why do performance differences even out? Reasons may be attributed to outlet capacity or lifecycle arguments. First, a franchise-specific explanation may be that every franchised outlet may have a maximum capacity to serve customers, because of technical reasons and the franchisor's territorial strategy. The degree of initial capacity being used is higher for the customer-transferring franchisees, while the others have to acquire customers bit by bit. Over time, the latter catch up, until they reach a similarly strong capacity utilisation. Second, a general argument may be that customer relationships exhibit lifecycle features, so transferred customers do not patronize an outlet forever. Eventually, they stop, possibly, as they stop buying the service category or come to prefer another seller. The literature on customer switching yields numerous reasons for churn behaviour (Keaveney, 1995; Reichheld, 1996), like service failure, pricing, competition, inconvenience (waiting times e.g.), even in cases where customers are basically satisfied.

From a theoretical perspective, our results illustrate the central significance of adopting a dynamic and comprehensive view when studying the strategic value of social capital for start-up performance. Besides, our study complements research on the impact of interorganisational and key customer social capital on start-up performance, and extends the analysis of implications of such capital to a broader view on intertemporal effects.

Concerning managerial implications, from the start-ups' perspective, understanding the interdependencies of customer capital and career prospects is essential for work-related choices. The impact of previously built customer capital affects career prospects even when becoming active in a different business environment. Whereas "starting over" in a new environment may be a tempting thought for many of us once in a while, success prospects are still path-dependent as the results point out that previously gained (or lost) social capital affects new endeavours.

Another challenge for start-ups is to effectively engage in customer-binding activities *before* start-up. From a practical point of view, this requires the capability of differentiating the management of business relationships and of selecting customers that are sufficiently loyal to stay – in addition to developing the managerial capabilities needed for start-up.

Besides, re-thinking some "common wisdom" in franchising is needed. One of the most-cited advantages of starting a franchised outlet as opposed to starting one's own independent business is that the franchisee is provided with initial training and ongoing support by the franchisor. Franchisors and franchisees have touted the mantra, "You are in business for yourself, but not by yourself". Accordingly, common wisdom holds that industry experience is not essential for start-ups in franchising. However, transferring a significant amount of customer capital may only be feasible when start-ups stay in the same industry as they have been in as employees of their former firm. The same holds for staying in the same geographical area. Then, who will be in "pole position" concerning performance prospects after start-up, is decided already prior to outlet opening – despite the alleged homogeneous starting conditions that franchise chains provide.

Good news for franchisees who *cannot* transfer customers is that finally, they will catch up with those who can. Good news for those who *can* transfer customers is that because initially successful franchisees tend to have more outlets later, good initial performance still pays off in the future – if not in the initial outlet, by being able to open more outlets over time.

To date, although franchisees are an essential ingredient in successful chains and franchising is so important in today's economy, few studies have analysed the determinants of franchisee performance (Dant, 2008; Michael and Combs, 2008). From the franchisor's

perspective, chains would greatly benefit if franchisors were more able to detect future high-performing franchisees in the pool of applicants and accept them into the system, rather than low performers (Jambulingam and Nevin, 1999). Jambulingam and Nevin (1999: 364) argue, “the ideal in building and maintaining a high quality network of franchisees is a selection method that would qualify prospective franchisees based on their likely future performance”.<sup>10</sup> Our results provide some insights into what makes a franchisee successful. Besides, franchisors do not only choose the franchisee, but they also choose an integral part of their future customers when accepting a franchisee into the system. As customer-transferring franchisees provide higher sales and thus higher profits to the system centre in the first years after start-up, franchisee screening and selection may need to develop tools that evaluate franchisees’ abilities to bring in customer capital. Possibly, it pays off to provide those franchisees that seem promising in terms of customer capital with a broader initial product portfolio than the average new franchisee, or to let their outlets introduce innovative products, as they may receive more feedback from customers and may be more able to promote product diffusion in the market than less successful system members. Because of higher revenues, these franchisees can also pay back entry fees faster, so offering better financial conditions to attract them into the particular system could be an option. Gibb and Davies (1990: 16) argue, “it is perhaps an unrealistic expectation that it will be possible definitely to pick winners or indeed to produce a comprehensive theory that leads to this. But arguably it is better to make further strides towards better understanding of the factors that influence the growth process”.

Additionally, results indicate that consumers do not necessarily choose the brand before patronizing a specific outlet as widely believed (Dant 2008), but loyalties can rather be based on the entrepreneur, *who makes consumers choose the brand*.

More research is needed to better understand the interplay of customer capital with other forms of social capital over the entrepreneurial lifecycle. Another area of research may concern the customers’ perspective, exploring how for them, the question of “should I stay or should I go” presents itself: what is the psychographic profile of customers that prefer the start-up over the start-up’s former firm? Based on longitudinal and dyadic start-up/customer data, such an approach will provide better guidance in forming and managing relationships – in selecting the “right” customer relationships to develop from the start ups’ perspective, as well as in selecting potentially “better” start-ups from a customers’ and franchisor’s perspective.

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<sup>10</sup> Studies on franchisee selection criteria focus on demographic factors like age, business or industry experience, personality, or financial strength (Altinay and Miles, 2006; Clarkin and Swavely, 2006; Jambulingam and Nevin, 1999; Wang and Altinay, 2008; Williams, 1998). Yet, there is little empirical support for which criteria lead to the desired results (Birley and Westhead, 1994; Jambulingam and Nevin, 1999; Saraogi, 2009); scholars conclude that franchisee selection calls for further research (Clarkin and Swavely, 2006; Saraogi, 2009; Wang and Altinay, 2008).

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## 5 Appendix

### Measurement Scales and Items

Note: The scales were considered formative constructs. Seven-point Likert scales are used to provide responses for each item, 1 – “Strongly disagree”, 7 – “Strongly agree”. Constructs and items are taken from Reinartz et al. (2004).

#### **a) Activities to Retain Customers (RETENTION)**

With regard to your start-up firm, to what extent do you agree to the following statements?

- 1) We maintain an interactive two-way communication with our customers.
- 2) We actively stress customer loyalty or retention programs.
- 3) We integrate customer information across customer contact points (e.g., mail, telephone, Web, fax, face-to-face).
- 4) We are structured to optimally respond to groups of customers with different values.
- 5) We systematically attempt to customize products/services based on the value of the

customer.

- 6) We systematically attempt to manage the expectations of high value customers.
- 7) We attempt to build long-term relationships with our high-value customers.

**b) Activities to Manage Up-Selling and Cross-Selling (CROSS UP)**

With regard to your start-up firm, to what extent do you agree to the following statements?

- 1) We have formalized procedures for cross-selling to valuable customers.
- 2) We have formalized procedures for up-selling to valuable customers.
- 3) We try to systematically extend our “share of customer” with high-value customers.
- 4) We have systematic approaches to mature relationships with high-value customers in order to be able to cross-sell or up-sell earlier.
- 5) We provide individualized incentives for valuable customers if they intensify their business with us.

**c) Activities to Manage Customer Referrals (REFERRAL)**

With regard to your start-up firm, to what extent do you agree to the following statements?

- 1) We systematically track referrals.
- 2) We try to actively manage the customer referral process.
- 3) We provide current customers with incentives for acquiring new potential customers.
- 4) We offer different incentives for referral generation based on the value of acquired customers.

## 6.1 Figures and tables

Table 1. Results

Category	Dependent Variable	Model 0		Model 1		Model 2		Model 3		Model 4	
		Sales Performance <sub>t-1</sub> (Start-up)		Sales Performance <sub>t-1</sub> (Start-up)		Perceived Performance <sub>t-1</sub> (Start-up)		Growth		Sales Performance <sub>t-3</sub> (Long-term)	
	Constant	5.124***	(1.023)	4.290**	(1.749)	4.322***	(1.567)	1.536***	(0.234)	2.765***	(0.366)
Social Capital and CRMEffects	Social Capital Transfer <sub>t-1</sub>			0.433***	(0.046)	0.373***	(0.033)	-0.035**	(0.012)	0.011	(0.035)
	Retention			0.052***	(0.009)	0.056***	(0.013)	-0.061***	(0.011)	0.032*	(0.012)
	Cross_Up			0.089***	(0.025)	0.082***	(0.021)	-0.069***	(0.014)	0.047**	(0.012)
	Referral			0.047***	(0.010)	0.051***	(0.009)	-0.052***	(0.013)	0.042*	(0.019)
	Social Capital Transfer x Retention			0.010*	(0.004)	0.011*	(0.004)	-0.013*	(0.006)	0.015	(0.032)
	Social Capital Transfer x Cross_Up			0.021*	(0.008)	0.029*	(0.012)	-0.022*	(0.009)	0.020*	(0.007)
	Social Capital Transfer x Referral			0.009*	(0.004)	0.008*	(0.003)	-0.009*	(0.004)	0.014	(0.012)
	Sales Performance <sub>t-1</sub>									0.532***	(0.100)
Socio- Demographic Effects	Age	0.001	(0.002)	0.002	(0.004)	-0.012	(0.016)	-0.002	(0.002)		
	Gender	0.102	(0.075)	0.007	(0.033)	0.173	(0.199)	-0.031	(0.031)		
	Education	-0.018	(0.014)	-0.005	(0.067)	-0.051	(0.030)	0.002	(0.003)		
	Previous Self-Employment	-0.223**	(0.088)	-0.064	(0.053)	0.028	(0.068)	0.037†	(0.022)		
	Leadership Experience	0.263***	(0.087)	-0.045	(0.065)	-0.019	(0.082)	0.014	(0.038)		
	Industry Experience	0.300***	(0.074)	0.129*	(0.055)	0.075	(0.097)	-0.020	(0.023)		
	Entrepreneurial Background	0.023	(0.031)	0.006	(0.018)	-0.042	(0.044)	-0.005	(0.006)		
Controls	Competition	-0.165*	(0.068)	-0.001	(0.007)	-0.003	(0.003)	-0.001	(0.000)	-0.010	(0.000)
	GDP	0.055***	(0.011)	0.043†	(0.021)	0.051†	(0.023)	0.018†	(0.009)	0.014**	(0.004)
	Outlet Size	0.178*	(0.074)	0.090*	(0.041)	0.139	(0.137)	-0.014	(0.023)	-0.019	(0.031)
F		8.335***		28.190***		21.567***		14.159***		26.318***	
R <sup>2</sup>		0.319		0.647		0.567		0.544		0.563	
Adj. R <sup>2</sup>		0.298		0.621		0.546		0.23		0.521	

Beta coefficients reported. Standard errors in parentheses. System dummies are included.  
Significance levels (two-tailed):  
\*\*\* p < 0.001; \*\* p < 0.01; \* p < 0.05; † p < 0.1

Variable	Mean	S.D.	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)	(9)	(10)	(11)	(12)	(13)	(14)	(15)	(16)	(18)
(1) Sales Performance <sub>t=1</sub>	10.71	0.30																	
(2) Sales Performance <sub>t=3</sub>	11.35	0.28	0.67***																
(3) Growth	0.24	0.08	-0.34**	-0.28*															
(4) Perceived Performance	3.32	0.34	0.57***	0.57***	-0.42***														
(5) Social Capital Transfer	3.15	1.32	0.66***	0.22**	-0.62***	0.46***													
(6) Retention	3.97	1.32	0.47***	0.22***	-0.42***	0.57***	0.50***												
(7) Cross_Up	3.18	1.10	0.66***	0.48***	-0.52***	0.38***	0.51***	0.64***											
(8) Referral	3.37	1.48	0.56***	0.34***	-0.41***	0.57***	0.46***	0.42***	0.37***										
(9) Age	41.58	7.15	-0.08	-0.06	-0.05	-0.16*	-0.18*	-0.21*	-0.22†	-0.25†									
(10) Gender			0.14	-0.04	-0.14†	0.12	-0.10	0.13	0.16	0.15	0.01								
(11) Education	11.25	2.78	-0.20*	-0.00	0.05	-0.09*	-0.06	-0.00	-0.00	0.00	0.04	0.14†							
(12) Self-Employment			0.26**	0.14	0.23*	0.10†	0.17*	0.25***	0.31**	-0.27***	0.21*	-0.13	-0.04						
(13) Leadership			0.25**	0.10	-0.32**	0.20**	0.24***	0.33***	0.37***	0.34***	0.13	-0.13	0.15	0.15					
(14) Industry Experience			0.33***	0.05	-0.26**	0.24**	0.45***	0.49**	0.39**	0.28*	0.08	-0.25	0.04	0.19*	0.15				
(15) Background	1.98	1.26	0.15*	0.06	0.04	0.00	-0.05	-0.00	0.02	0.01	-0.06	0.09	0.00	0.17*	-0.03	0.03			
(16) Competition	2.39	1.14	0.12	0.09	-0.03	0.16	-0.12	-0.10	-0.08	0.00	-0.09	-0.07	-0.06	0.14	0.00	0.03	0.21*		
(17) GDP	1.02	0.07	0.04	0.15†	0.08	0.17†	0.11	0.09	0.09	0.04	-0.03	-0.04	-0.02	0.00	0.08	0.19*	0.06	0.27**	
(18) Outlet Size	1.95	1.83	0.43**	0.35**	0.11	0.17†	0.11	0.16	0.15	-0.13	0.14†	0.13	0.10	0.26***	-0.02	0.18†	-0.12	-0.07	0.22**

Significance levels (two-tailed):  
 \*\*\* p < 0.001; \*\* p < 0.01; \* p < 0.05; † p < 0.1

Table 2. Descriptive statis