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Characteristics of entrepreneurial networking practices through different phases of establishing a novel innovation firm

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Abstract: The purpose of this paper is to examine the characteristics of decision making in the entrepreneurial networking practices through different phases of establishing a novel innovation firm characterised with high level of product or service innovativeness and lack of resources. The paper first presents different stages of establishing a firm and its' distinctive characteristic. Then we explain the characteristics of networking in different stages of the establishment of the firm by the means of two analytical models – that of March's "Exchange power model" and Burt's "Structural holes model" in the terms we have called "*soft*" and "*hard*" networking. We end with the proposal of sequential use of various networking practices for the purpose of better resource orchestration and leverage of power.

Keywords: entrepreneurial networks, decision making, start-ups, innovation, management

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INTRODUCTION

Starting up a firm is always done by imitation to some extent. However, there is a great variety in the character of the innovative element of the start-up. If the innovative element is small, we assume that the potential profits are low but so is the level of risk. An example of this would be starting up a barbershop, or a hamburger bar.

If the innovative element is big, both the potential profits and risks are high. An example of this would be an airline company with planes based on an inexpensive anti-gravity generating system. In this case, the risk involved would be a complex compound of various elements. Consequently the risk would be less easy to communicate about. The emphasis here is on the innovative element. We assume that it is the company that gains control of the innovative element that is able to extract the profit. In this paper we will discuss starting a firm in this second category, where the innovative element is big. Seen from the innovators perspective the question is: How can I maintain control over my innovation but still create value?¹ Teece [21] shows that maintaining control by the innovator cannot be taken for granted.

The well documented Schumpeterian notion of innovation as an element of market disequilibrium is also argued by Hitt et al. [cf.8] who state the following:

Creating novel (radical) innovation often requires a significant investment of time, effort, and frequently financial capital as well. Because firms rarely have the resources needed to achieve this type of innovation internally, they frequently search external sources to locate them. To do so, they may need to develop networks of partners...Frequently, new venture firms are more creative and thus can develop more novel innovations, while established firms are effective in adding new features to and improving their current products to maintain an advantage in the market. (p.67)

In this paper, first we will explain the characteristics of networking with respect to the ability of the player to reap the fruit of the potential start up. In order to present that, we will use the Exchange Model of Power by March [17] and the Structural Holes Model by Burt [2]. After that we will explain different stage of starting a firm and continue by explaining the characteristics of networking in each of the stages. Moreover, we will continue with combining these two theoretical principles in order to define the characteristics and concepts of what we call “soft” and “hard” networking. We will shortly present various networking practices and then offer our solution of the necessity of their sequencing, in order to better orchestrate resources [cf.8] and leverage power.

POWER EXCHANGE AND USAGE OF STRUCTURAL HOLES IN NETWORK CREATION AND RESOURCE ACQUISITION

Kumon [15] states that network represents a set of actors coming together to share useful knowledge and information, by which they should achieve mutual understand-

¹ For the discussion of value creation by entrepreneurs see [8].

ing and a basis for further collaboration with the main ingredient that of mutual trust. Networks are there to provide both individual and the collective, with attainment of individual/mutual goals. The crucial element for the entrepreneur to start a business becomes *resources*, [7] which they either possess on their own or use networking to get them ([24]; [10]; [19]; [22]). Burt [cf.2] defines resources that a player brings into arena as that comprised: financial capital, i.e. cash and cash equivalents, human capital, i.e. individual's personal qualities fortified by the knowledge gain through education and experience, and social capital, i.e. various relationships with other players/stakeholders.² He continues in arguing that, since the reality on the market is imperfect and not perfect competition, social capital becomes final arbiter of competitive success. Even if an entrepreneur possesses knowledge and financial capital, if the social capital is inadequate there is greater risk of failure. These go in line with Teece [cf.21] and his analysis of why innovators do not necessarily obtain the economic returns from their innovation. He argues that in different environmental positions (dependent on the nature of technology, efficacy of legal mechanism and the stage in evolutionary development of particular industry) different channel strategies should be made with respect to acquiring complementary assets. Whether an entrepreneur contracts or builds manufacturing, distribution, service etc. will be highly dependent on imitativensness of product, the existence of dominant design and the generic resources that can be used.

As Teece [cf. 21] himself argues: "... a profit seeking innovator, confronted by weak intellectual property protection and the need to access specialized complementary assets and/or capabilities, is forced to expand its activities through integration if it is to prevail over imitators." (p. 296)

In the competitive arena each of the players has its own network of contacts. Burt [cf.2] argues that, networks as a social capital, provide entrepreneurs with profit, measured by the rate of return on a particular investment. The increase of the rate of return on particular investment will be dependent on the power and control of the entrepreneur in the competitive arena. March [cf. 17] takes it a step further from increasing the return of the investment to saying that entrepreneur wants to fulfil his/her own preferences and identities.

According to him, the power is the ability of the actor to get what he/she wants. The basis of it lies in the inconsistent preferences and identities of each of the actors in the process of decision-making. Since the existing environment is too narrow for every one of them to get what they want, the power becomes the desired capability of the actors to align the decision making process with his/her preferences and identities. To exhort power and gain control the actor, in our case entrepreneur uses the so called structural holes or non-equivalencies between the players in the arena [cf.2]. Dependent on the structure of player's network and the location of the particular contacts actor can benefit from the access to information which he/she could hardly obtain on his/her own.

² For thorough discussion on social capital see [11].

In the exchange model of power, each of the participants enters into voluntary exchange relationship regulated by some set of rules. Those rules are created by the characteristic of the structural autonomy of the networks existing in the particular market. The more the parties are plenty and disorganized the more there is the opportunity for taking the advantage of the structural holes and vice versa [cf. 17].

For example, if an entrepreneur-producer enters into a low-autonomy network of dominant customers and suppliers, who amongst themselves are interconnected, which means that structural holes are scarce, then the rules of the game (share in profit, price etc.) are established by that dominant parties. The producer here will end up with minor share in profit, regardless of how massive supply and demand is.

The inconsistencies between the actors in the arena will be removed by the power of the dominant parties and can be based on:

1. aligning the incentives, by for example contracts, threats and deterrence and
2. aligning the identities and rules by for example, selection of partners with similar background, education, talents, interests into decision-making process [cf.2].

As we stated earlier, each of the participants brings into the arena different kinds of resources and seeks to improve his/her position by trading with other participants. Lack or abundance of structural holes becomes a constraint or an advantage for an entrepreneur eager to enter certain market. The ability of the entrepreneur to pursue his/her own preferences or fulfil his/her own identity in particular market depends on 3 things [cf.17]:

1. who has control over the rules, since he/she sets the playing field for decisions and has the power to constrain them
2. who has control over resources, especially the resources desired by other person since the controlling party can then demand in exchange what they want and that does not necessarily have to be reciprocal in nature
3. who has control over preferences and identities, meaning that the true power lies in the capability of the actor to persuade other parties in decision-making process that what he/she has is exactly what the other party wants. Instead of seeking to provide things that other actors want, the controlling party induces others to want the things he/she can provide.

Combining this view with Burt's thinking, the control in the arena or market is executed by the power of structural holes. If the entrepreneur comes to the market with his/her own autonomous network, his/her negotiating power increases with respect to the lack of organization and inter and intra connections between the other players in the market. Thus, such social capital which entrepreneur brings makes it into a productive asset [1] making possible certain decision making which would be if not impossible, than very difficult without it. The more the market is unorganised and rich in players the more the

entrepreneur can exert control by being sort of a broker or *tertius gaudens* (the third who benefits) between the different parties in the environment [cf.2].

Of course, the nature of the networking varies in different phases, and power and control have another meaning at different stages of the establishment of the firm.

Johannisson [12] states that establishment of the firm follows a spiral change model. It begins with the intuitive idea, a vision that will guide and govern future actions through development of a venture concept. Such a venture concept then becomes basis for the linkages with the environment.

STAGES IN THE ESTABLISHMENT OF THE FIRM

Based on the literature ([20]; [23]; [cf. 12]; [cf.7]) we have chosen to follow a three-stage model of establishment of the entrepreneurial firm. The following chapter represent its' short presentation.

The first stage in the establishment of the firm, starts with the elaboration of this vision, the idea to the family and close friends, since entrepreneurs do not want to make any widespread commitment to any potential choice [cf.7]. This is the stage which Wilken [cf.23] calls *motivation stage*; Stanworth and Curran [cf.20] refer to it as the artisan latent social identity of the entrepreneur. Following the Stanworth and Curran model, Johannisson [cf.12] continues that ties between the artisans or the founding managers and their community are based on moral commitment and trust. The function of this closest community is to give the artisans a mental support and a frame of reference in materialising entrepreneurial vision.

In the second stage, entrepreneurs are prone to contact large set of people, since they do not know specifically who could be of greatest help to them [cf.7] For Wilken [cf.23] this stage is called *planning stage*. For Stanworth and Curran [cf.20] this is the stage where artisans break away from social norms, i.e. ingrained traditions [cf.12] and are adopting the identity of the entrepreneurs. Their arena becomes the market and this is the stage in which they spend most time maintaining and developing contacts [cf.7]. They also use their personal networks and mentors, i.e. persons who will incorporate them into possible wider structures, as a potential safety net [cf.12].

In the third stage, the *establishment stage*, the business is running and entrepreneurs use networks more as the resource bank [cf.20] concentrating on the key persons who provide them with the resources and commitment [cf.7]. Relationships are managed by contractual and barter relationships [cf.12]. In Stanworth and Currans's model [cf.20] entrepreneurs become managers, with built social position, which is only increased and maintained (legitimised) by membership in social clubs, professional societies and political associations.

THE NATURE OF NETWORKING IN VARIOUS PHASES OF ESTABLISHING A FIRM – “SOFT” AND “HARD” NETWORKING

Johannisson [cf.12] argues that an entrepreneur’s personal contacts play a dual function. First they provide social support, a safety net, which allows the entrepreneur to break social norms in the process of risk-taking. Second, the entrepreneur’s personal network is an instrument by which one acquires environmental resources, and it is the vehicle by which the organisational mission is carried out..

As we stated earlier, the essence of the networking is coming into the possession of the resources, which entrepreneurs do not possess themselves. As the establishment of the firm proceeds, the nature and characteristic of the networking changes, with respect to the:

1. consistency and alignment of the identities and preferences of the actors and
2. the terms on which the relevant resources are acquired [cf.17]

Previous research has shown that social networks will influence the outcome of entrepreneurial actions, dependent upon the people’s original positions and by thus will influence the nature of resources provided by the social networks depending on the strength of the ties. [16]

In order to depict the nature of networking in various stages of firms’ establishing, taking into consideration March’s exchange power model [cf.17] and Burt’s structural holes idea [cf.2], we have coined the terms “soft” and “hard” networking.

“SOFT” NETWORKING

In the first stage of a start-up, *the motivation phase*, we assume that the entrepreneur is networking without making any formal contracts with the people in the network. Networking is done first within the entrepreneurs existing network, the so called high density network [6].

Gradually the network extends beyond the initial network and includes new actors. This is especially important if the entrepreneurs have some basic idea which can be potentially copied, thus the lower density networks are needed, in order for the idea not to be imitated or potentially stolen [cf.6]. The networking in this phase is mapping out the features of the environment in which the future firm is going to be placed. The different features of the landscape are being analysed, that give the entrepreneur clues where to move next to gain more information on aspects vital to the business idea.

The networking is characterised by certain softness, because in this phase the entrepreneur is not offering much in return to his/her contacts other than doing the good deed of the day. The networking in the first phase is characterised by aligned and consistent preferences, to a greater extent than in any other phase. The entrepreneur is also learning about the identities and preferences of the new actors in the network. ([cf.17], [cf.2])

However, the soft networking leads up to a change, because underneath this soft atmosphere, the ambitions of the entrepreneur are lurking and in this mapping process, some contacts become more important for the realisation of the start-up than the others.

“HARD” NETWORKING

Morris [18] claims that resource acquisition and application is one of the most salient but under-researched issues affecting start-ups. As Klyver et al. state [14]: “Among the most important resources that networks can provide are:

- Information (sensible as well as non-sensible, diverse as well as non-diverse)
- Access to finance
- Access to skills, knowledge and advice (all aids to competency)
- Social legitimacy
- Reputation and credibility” (p.332)

When you look at a budding organisation, you see that the way it is identifying, acquiring and combining its resources, creates the unique identity of the firm, and that this also place limits on the scale and scope of the firms operations, determining the strategic direction of the venture. It goes in line with the so called strategic entrepreneurial mindset which is not only preoccupied with sense making and questioning of predominant decision-making logic in the context of changing goals and environment, but it is also a mindset capable of revisiting truths one has about the existing markets in order to orchestrate restructuring and acquiring scarce resources ([9], [cf.8])

Starting from *planning* stage particularly and on to the *establishment* stage, the networking takes on a different character, it becomes *hard*. The alignment of preferences is to be established based on the notion of who controls the resources and thus makes the rules of the game. Networking becomes the arena in which both of the parties want to exhort as much control as possible and induce the others to want the things/he she can provide. ([cf.17], [cf.2])

Generally, the entrepreneur enters into *planning* stage with a weak negotiating position, because she/he has little to offer in return, other than the option of a relatively high yield for the resource owner if they can reach an agreement of an “if ...- then ..” nature. The entrepreneur cannot offer concrete and binding orders, because the decision to enter the *establishment* phase is to be made. As we pointed out earlier, keeping the essence of the business idea relatively diffuse for the resource owner, in this type of negotiation, is important, but it further weakens the position of the entrepreneur, because the resource provider will perceive the diffuseness as an increased risk. The resource provider is also, in most cases, someone who is able to determine the rules of the exchange because of the special knowledge of the resource the provider is controlling. Thus, as Teece [cf.21] argues, unless the business idea is innovative enough to

enable one to gain control over the complementary assets needed to make and sell the product, weak negotiating terms will do little to start a new entrepreneurial venture.³

When the entrepreneur starts to plan, he/she does that with an essential task of identifying the cost of the resources that goes into the product or service, or the cost of gaining access to places or streams of information that are a necessary input to the firm. To be able to produce a trustworthy start-up plan, it must be based on known numbers, or numbers that can be documented. For resources that are readily available in the market, there is no need for vast documentation, but for resources that are scarce or not readily available in the market, one has to document some kind of agreement with the provider of such a resource. It is these agreements, which have to be negotiated. (for discussion on the challenges of constructing a resource base see [3]).

SEQUENTIAL USE OF NETWORKING PRACTICES FOR RESOURCE ORCHESTRATION

Taking into consideration the changing nature of networking practices with respect to different phases in establishing a firm, the question arises of what kind of networking practices should a prospective entrepreneur use in order to leverage his/her weak negotiating position and acquire necessary resources. The solution we propose is the one of sequencing between various networking practices which will be presented below. First we will shortly present various networking practices possible and then present our solution.

SHORT OVERVIEW OF NETWORKING PRACTICES

Influence of different cultures on networking practices, with respect to its' universality or context determination has been a researcher's interest for decades (for thorough discussion see [cf.14]). For the purpose of presenting our arguments, we will use the classification proposed by Zhao and Aram [cf. 24].⁴ In their article on networking and

³ Competitive advantage often results from the control of valuable and rare resources. For review and discussion see [cf.8]

⁴ We are aware of the cultural determination of certain networking practices, but for the purpose of elucidating ideas in our paper we are following the line of thought presented by Kylver et al. [cf.14] which in arguing for universality or cultural determination of networking practices, proposes the following classification based on Lonner's writings: „The term 'simple universal' means a phenomenon is constant worldwide. 'Variform universal' refers to a general relationship that holds across countries, but which is moderated by culture. 'Functional universal' refers to situations where relationships are the same within groups.... It is not longer a matter of either being totally universal or totally cultural determined.“ (p.344). Their study of networking practices suggested in 20 countries suggests its' „variform universal“ nature.

growth of young ventures in China they give overview of various mechanisms that are applied to balance out the power between the entrepreneur and her/his environment – starting from long term mechanisms of cooperation (e.g. licensing agreements, joint production development, long-term subcontracting), mutual mechanism (e.g. offering free trials, providing market and technical information of products) to informal mechanism (e.g. business lunches, gift giving) and arm's length contacts (e.g. business calls and meetings).

SEQUENCING OF NETWORKING ACTIVITIES AND ORCHESTRATION OF RESOURCES

All of these mechanisms are, we imagine, used in *establishment* stage of the start-up, but in order to get to the third stage we believe that first two stages require sequencing, i.e. using each of the mechanisms at the appropriate time, starting with informal mechanisms, and ending with mechanisms for long term cooperation.

But why not go directly to the negotiation of mutual mechanisms and the long-term contracts? Why is this sequencing so important? According to March [cf. 17] in the negotiation process one exchanges power. We have already seen that the entrepreneur is in a weak negotiating position.

However, we claim that by sequencing the negotiations between the different resource providers, the entrepreneur can gradually develop the resource base and gain more negotiating power. The negotiating power is gained by acting as an alternating agent for different resource providers in the new firm. It is by acting as an agent for different actors that would not otherwise meet to discuss and investment in the new entrepreneurial endeavour, that the entrepreneur is able to create a position in the marketplace.

One important issue especially for entrepreneurial ideas with high innovativeness and lack of resources needed for its' realization, is the potentiality of imitation and theft. Hitt et al. [cf. 8] argue that in order to successfully orchestrate resources, some level of protection of both intellectual property and complementary resources is needed. This provides negotiating power to the entrepreneur, much needed especially with scarce or no resources to execute his/her idea successfully in the market.

How then is the negotiating power used? It helps if a start-up has patents or "preemptive patents" ([25]; [cf. 8]) however it need not be the only course of venue, especially with start-ups who lack resources (especially finances). Negotiated contracts [5] might also be the way to leverage on power. If the entrepreneur is willing to offer the resource provider high yields for the resource, but in return for that, the resource provider must give the promise not to infringe further into the room that the innovative element creates. This is especially true for innovative, hi-tech industries, where experimentation is required from both the entrepreneur and the resource provider (for discussion and examples see [13]).

At the start of this process, the resource provider is willing to accept this, since the perceived risk is so high. Later in the process the perceived risk might have decreased, but

then the entrepreneur has gained a position based on the initial contracts made by the parties, and the risk of losing a good contract becomes the risk the resource provider has to face, even if infringement would be more profitable.

If done successfully, the entrepreneur should be left with a certain room of profitability created by the innovative element, and the resource providers partly dependent on the firm, as a “customer” for their resources.⁵

There are many ways to start negotiating with the different actors, but keeping March’s power exchange model [cf. 17] in mind, one can assume that the most successful sequence would be starting the negotiations with the resource providers that are in the weakest negotiating position and that are the less likely to infringe on the room created by the innovative element.

CONCLUSION

In this paper we have looked at the entrepreneurial activity and the different phases of starting up a firm and put it into relation with March’s [cf. 17] theory of decision making and Burt’s [cf. 2] structural holes theory. We then defined the entrepreneurial endeavour, as acquiring resources from other actors, without having proprietary resources in the initial phase. We also stated that there was a difference between start-ups with a small innovative element and those with a large innovative element and that we would discuss the latter category.

In some sense there is an ambiguity in the entrepreneur’s relation to the networking environment. This paper discussed one possible explanation for this ambiguity. The networking activity went from soft in the *motivation* stage, to hard in the *planning* and *establishment* stage. The shift is caused by the need of the entrepreneur to gain control over resources that are necessary for the new firm, and must engage in negotiations with actors in the network. We also concluded that, initially the entrepreneur is in a weak negotiating position.

The second hypothesis we suggest one can draw by using March’s model, is that entrepreneurs must develop their network assets in sequences. By sequencing, the entre-

⁵ Coff [cf. 5] described the story of Tony Faddel who „had the original idea for a hard disk based music player coupled with an online music store. This required multiple resources and capabilities that he lacked. Over time he partnered with Apple, PortalPlayer (designer of the chipset and firmware), and an array of other suppliers.“ (p. 712). He offered first his idea to his former employer, Philips Electronics, then tried his own failed venture, before turning to Apple. In order to protect his asset, he first started as the contractor with Apple, then based on his critical personal complementary assets, which were comprised of him being and innovator and knowledge of innovation, he became senior executive with large equity, gaining almost 38 million dollars for the creation of new value ([cf.5]; [cf 8, p. 66]).

preneurs are able to gain leverage in their position relative to the other actors, and in that way create their own resource and power base. If sequencing is not used there is the possibility that resource providers in the network, will take over the room that the innovative element has created.

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