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Venture Capitalists' Investment decision criteria for new ventures: A Review

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Abstract

Venture Capitalists (VCs) play the most crucial role to identify high potential and innovative firms. However, VCs adopt different criteria to evaluate the incipient ventures before funding. The purpose of this paper is to discuss the comprehensive literature of the VCs investment evaluation criteria. This study provides a critical review of the conceptual and empirical approaches focusing on how VCs make their investment decision and what are the key influential factors at the times of investment. The critical examination highlights that not all the VCs able to follow the same investment decision process for evaluating new ventures. Some VCs give more importance to entrepreneur's characteristics, while others are more intrigued with financial and marketing perspectives. Thus, findings reveal that VCs follow multi-criteria perspective of the decision-making. This study discusses the various issues and suggestions for future research. The results of the study are useful for both venture capitalists in their decision-making process and entrepreneurs in their venture capital applications to maximize their success rate.

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Keywords: Venture Capital; Investment evaluation; Decision-making; Venture Capitalists

1. Introduction

With the rising knowledge-intensive economy, Venture Capitalists (VCs) play the most crucial role to identify and financing the new and highly innovative firms. VCs decision criteria have been facing numerous challenges to

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identify the economic value of the new venture, and it has been considering as the most complex task of a decision-making process (Mechner, 1989). A large number of researchers and academicians have examined the VCs decision-making process (Wells 1974; Poindexter 1976; Tyebjee and Bruno 1984; MacMillan et al. 1985; MacMillan et al. 1987; Khan 1987; Robinson 1987; Timmons et al. 1987; Sandberg, Schweiger, and Hofer 1988; Hall and Hofer 1993; Zacharakis and Meyer 1995; Zacharakis 1995; Zacharakis and Mayer 1998, Zacharakis and Shepherd 2007). It has become the most important decision due to the fact that Venture Capital (VC) backed firms have the higher survival rate as compared to Non-VC backed firms (Sandberg 1986; Kunkel and Hofer, 1990; Timmons, 1990).

The VC process includes a series of activities that starts with the proposal of new venture and continues until the successful exits with adequate returns. Tyebjee and Bruno (1984) firstly proposed a five stages VC process model. These include: (1) deal origination - identifying potential firm; (2) deal screening - reviewing proposals particularly in technology, product and scope of market; (3) deal evaluation – assessment of a business plan (risk and return); (4) deal structuring – negotiating and mutually establishing VC agreement and (5) post-investment activities – providing value-added activities. VCs spend most of their valuable time for taking the best investment decision. Gorman and Sahlman (1989) noted that VCs spare 110 hrs per year to assist and monitor one venture. VCs performance can improve with the better understanding of an investment process, and it leads to improve the time efficiency and overall returns (Zacharakis and Meyer, 2000). In this paper, we discuss the screening phase of decision-making process or criteria used in investment decision process. VCs screening criteria differs with different ventures based on the type of industry, geographic location, stage and size of investment. Sorenson and Stuart (2001) stated that VCs often specializes the investment criteria on industry basis. Based on literature, while VCs differentiate investment criteria with different objectives, the basic categories are entrepreneur's characteristics, product, competitive strategies, market size and growth, but the primary difference is how criteria weighted differently.

The primary goal of this study is to review the progression of VC investment decision and the screening phase. The investment decision is more sophisticated field for VCs that how they decide to select the ventures and the factors that influence their decision (directly or indirectly). This study starts with the review of early research and the methods used for analyzing the criteria used in VC decision-making process. The next section, deals with the various issues involved in decision-making process. It also discusses whether biases manipulate the rational decision-making. Most of the ventures assume that VCs follow the relatively homogeneous process, but findings reveal that VCs follow multi-criteria prospective of decision-making. This study not only converse about earlier research, it also reveals various issues and explores future avenues.

2. The evolution of VC research

The investment process is an element of the "Venture Capital Cycle". The earlier VC research focused more on the interviews and questionnaires, but now it became more sophisticated and progressed area. Sandberg and Hofer (1988) raised the concerns about the methodology used during surveys and interviews due to the human decision-making process. This section provides the outlook of verbal protocols and conjoint analysis. Verbal protocol allows researchers to 'think aloud' and tells how to use the necessary information while screening a potential deal during the decision-making process. Conjoint analysis allows the researcher to capture and use the important criteria during decision.

2.1 VCs screening and evaluation process

VCs are relatively able to predict the new venture proposals successfully (Sandberg, 1986; Hall and Hofer; 1993). Zacharakis and Shepherd (2007) exposed that numerous studies have empirically used the 'espoused' criteria reported by the seminal articles while evaluating the new ventures. A number of studies have undertaken the principle evaluation criteria as determined by the Tyebjee and Bruno (1984); Macmillan et al. (1985); Macmillan et al. (1987) and Sandberg and Hofer (1988). The earlier studies focused on the criteria used in the evaluation process and not examined the decision-making process adequately. Tyebjee and Bruno (1984) explained four distinct categories such as market potential, management, competition and product. Macmillan et al. (1985) differentiated the different criteria into six different categories and finds out that entrepreneur's and team characteristics are the most important criteria to distinguish the successful and unsuccessful ventures. Most of the studies are agreeing on