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A Study on the Factors Affecting Investment Decision of Venture Capitalist

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Abstract: This article examines the importance of venture capital to the financial industry and the world economy over the past 30 years. Venture capital is a powerful driver of the U.S. economy and the world economy. Further, this paper cites the research results of different authoritative authors from SSRN for a comprehensive discussion. The data source of this paper mainly uses the form of a questionnaire survey. This article mainly explores the standards and procedures used by eight venture capital firms when making investments. These criteria are generating deal sourcing, investment selection decision, tools and factors in the evaluation, contracting and structuring the investments, monitoring and post-investment value-added, VCs' exit, firm internal structure, and relationships. In the end, this paper refers to the importance of factors for venture capital firms to make decisions in different periods. Comparing different research results, it is shown that not only eight factors are the factors that determine venture capital firms' investment decisions, but also luck is part of the reference factor.

Keywords: venture capital, entrepreneurship, entrepreneurial decision making

1. Introduction

Venture capital (VC) has been a significant force behind some of the most active sectors of the American economy over the past 30 years. Venture capitalists have played a big role in promoting companies like Microsoft, Oracle and Apple. Although these companies were founded in a short period of time, they have become major forces in the world's high-tech field. It is widely acknowledged that venture capital is an important factor in helping high technology enter the market, helping the world economy to grow and create jobs. The goal of this article is to understand the criteria and factors that help venture capitalists select investment projects. Investment in the early (seed and start-up) and later (growth) stages of the venture capital climate is required for analytical reasons. The determinants of venture capital have varying effects on various forms of venture capital.

Before discussing venture capital, it is needed to clarify the use of nouns. Private equity investments are those made in publicly listed or privately held businesses by organizations or individuals with sizeable assets. One of the elements that will be taken into account in this article is the fact that private equity investors are more actively involved in managing portfolio firms than retail equity investors. There are three types of investment - seed, venture and expansion. One of the elements that will be taken into account in this article is the fact that private equity investors are more actively involved in managing portfolio firms than retail equity investors. Seed money is the initial

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type of financing that a new business is most likely to obtain. The first stages of creative research and product development were financed using these monies. And they evaluate the business potential of the companies they invest in. Start-up investments are for companies that are past the initial idea and creative stage and ready to manufacture, market, and sell their products. Early-stage investments also include those made at the seed or start-up phases. A company starts to qualify for investment in expansion once it has passed the initial stages. During the expansion investment phase companies need to already have a product in the market, and need additional capital to create manufacturing and distribution level funds, as well as funds for further research and development.

New capital raised is defined as the total amount of money raised for all private equity investments, including capital already committed but not yet disbursed. According to Sahlman, typically, capital promised to the entrepreneur by the investor is not immediately paid to the investee [1]. Most agreements require a 25 to 33 percent cash commitment upfront and specify a time period for phasing in additional cash at a future date. The total amount of money committed to the entrepreneur is called commitment, but half of the initial amount is only a third of the money that goes to the entrepreneur.

The venture capital industry is a comparatively tiny and well-connected industry. Meetings were used to conduct the study, and instruments for learning about and understanding participants' cognitive thinking included questionnaires and structured interviews. The inconvenience and annoyance that mail-in or email-only surveys bring about can be avoided using this research methodology. These questionnaires are typically regarded as deficient since they frequently lack the professional notions and terminology of practitioners.

2. Standards of VC's Decisions

There are different standards considered important by the venture capital companies. This paper will discuss the most related and important eight different standards. For example, generating deal flow, VC deal selection decisions, the tools and assumptions they used, VC contracting and structuring the investments, VC monitoring and add- value after investment, VCs' exits, internal firm structure, and relationships. This paper will separately discuss these standards based on the existing survey paper and their questionnaire data analysis all from SSRN web.

2.1. Deal Sourcing

Deal sourcing is defined as the funnel and sifting through to get a small number of trades finally in the process to invest. This process is built up as multi-phases. Firstly, there will be a worker who found out or initiated a potential deal in the industry. Then if during the initial assessment led by the VC company, this investment project starts to show good potential, then there will be several meetings back and forth with the management team of startup companies. If they continue providing a deep impression to the VC company, the project will be led to other members of the VC company and then get into a further assessment. Furthermore, the VC project will be valued and assessed by other partners of the VC company. If the project goes through due diligence. If the startup firm accepts the parameters of the term sheet, the legal document will then be produced by the legal team, and the commitment letter will be signed. Next, the startup company will be given a letter of investment intent paper explaining the VC's financing terms. Therefore the deal is on the table. According to the survey, over 30% of the deal is initiated by professional VC network, 20% deals was recommended by other investors and 8% deals comes from investment portfolio companies [2].

2.2. Investment Decision Process

Schumpeter argued that innovation has no economic value in itself, but only when it creates new combinations of products and services. According to the study, the management team is the most

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significant consideration in this sector and more than 33% of VC organizations do not have an industry preference. Instead of using their own senior staff members for screening, venture capital firms utilize domain experts. Many of the VCs interviewed said that not all business plans can be subjected to the same intensive analysis. That this process is too labor intensive is the most cited reason, so the process will be graded screening. The generation of both active and passive transaction flows can have an impact on the business plan screening process. A hierarchical screening approach is preferred if the company plan is the result of passive deal flow, with junior personnel performing the initial screening. In this case, it can identify better investment opportunities, having more active deal flow. Active deal flow is generated when companies are not accepting unsolicited business plans.

2.3. Valuation Factor

Valuation process is the process that is used when a VC company used to assess and evaluate the value of the start-up companies or certain projects. More successful businesses and larger capital are more focused on product and valuation, and less on fit or delivering value. High-quality VC firms can win deals even if they submit term sheets at low valuations. American venture capital firms typically invest with convertible preferred shares. When constructing a valuation, the factor exit considerations are the most important factor. Because the IT sector is more cutthroat than the healthcare VC sector, its founders have greater negotiating power. Early and late VC- stage valuation methods are also different. It is generally considered that DCF or NPV is used for valuation. According to the survey, it turns out that the valuation mainly depends on IRR and P/E ratio. In addition, ten percent of investors don't apply any metrics on the value assessment.

The most popular technique for evaluating the success of business ventures and private investments is internal rate of return (IRR). IRR is referred to as the discount rate that causes a series of cash flows' net present value, or NPV, to equal zero. But IRR, as an important measure of private partnership performance, expects managers to strategically time their cash flows. Whether or not this is done in practice, it is important to know the incentives a performance indicator provides. In life, it cannot be ruled out that some managers can take advantage of the defects of IRR and think of improving their performance. So it's important for investors to understand these incentives

Unicorn company is a hot word in the 21st century. According to ilyastrebulaev, more than 40% of Unicorn founders are CEO of unicorns, and more than 17% of Unicorn founders are CTOs of unicorns. Also, the unicorn company is defined as companies with an implied valuation of more than $1 billion. However, according to research done by Gomper et al, 91% interviewee think unicorns companies are overvalued [2].

2.4. Contract

The deal structure is the establishment of a venture capital contract. The reason that deal structure and contract are important is that it helps VC companies stay the same if the entrepreneur is doing well, taking over if the entrepreneur is not doing well by carefully distributing cash flow rights, control rights, liquidation rights and terms of employment. Every term in the contract is used in favor of the investors rather than the entrepreneurs. Basically, there are three main considerations in the dealing contract: period pool right, vesting right and control right. A group of shares designated as a pool option is used to reward and inspire workers. Grant partial forfeiture of shares to employees whose founders leave the company. Board seats, the ability to reject crucial choices, and protection clauses all fall under the category of control.In order of least negotiable terms for VC companies, according to a 2016 poll by Gompers et al., are vesting rights, valuation and board control, anti-dilution protection, liquidation preferences, and proportionate rights. The parameters of dividend-call-option pool-participation, investment, and VC are the most flexible [2].

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2.5. Post-investment Value-added

Post-investment value-added includes improved governance and active monitoring. Venture capitalists have two roles, the first is to assess the quality of the venture by screening deals, and the second is to add value to the venture by mentoring. VC mentoring is the process of actively adding value to the venture. These activities include providing ideas for their business plans or discussing marketing strategies, or setting up personas to help VCs monitor start-up findings ahead of subsequent funding.

Venture capital is crucial for start-ups to specialize and is a key aid in hiring outside managers and directors. Firstly, investment companies interact with entrepreneurs frequently at least 60% interact with investment companies once a week. Regardless of their area of expertise, VCs actively participate in every crucial stage of investing in a company. These stages include capital raising, exiting, hiring executives, and deciding on strategic objectives. 87% of VCs assist portfolio companies with their strategic planning. In order to find investors for upcoming investment rounds, 72% of VCs assist their companies. 65 percent of VCs offer operational advice. The data suggest that investor connections are more important to early-stage investors. Additionally, Californian VCs will get more involved in assisting businesses in finding clients, maybe as a result of the fact that they operate in a cluster environment that enables them to have greater connections throughout the ecosystem's supply chain. In conclusion, venture capitalists actively contribute value to the firms they participate in rather than acting as passive investors. According to Gomper, the industry's ratio of tangible assets to total assets is declining, while market-to-book ratios are rising and R&D intensity is increasing [3]. Through board representation, venture capitalists are actively involved in the business. Venture capitalists are more open to serving as directors when there is a stronger need for regulation, according to Lerner [4].

2.6. Exits

The actual and type of exit are crucial to the success of a VC investment because VCs only receive a profit share or benefit when they return funds to investors. According to the data provided by Gompers et.al, fifteen percent of launches are through IPOs, fifty-three percent of exits are through mergers and acquisitions, and thirty-two percent of exits are due to failure [2]. The survey compared the data from different sources and found that the results were consistent with each other. There is a notice that many mergers and acquisitions are failures in disguise. For exit mechanisms, there are many mechanisms for liquidating funds. According to the literature, the IPO is the most alluring exit strategy and is what the majority of VCs will pick. According to research published in venture Economics in 1998, a firm that eventually went public had an average holding time of 4.2 years and an average greenmail return of 195% for every dollar invested. An investment of the same magnitude in an acquired company, with an average holding period of 3.7 years, provides an average return of only 40%. So, the data shows that an IPO is clearly the best choice for venture investors. In addition, through the IPO form, the investee can also regain stock and control of the company. After the initial capital, limited partners may leave the partnership. In reality, limited partners very infrequently leave a partnership. In subsequent fund-raising efforts, they are more likely to refuse venture capitalists further funding. It is specifically prohibited for venture capitalists to engage in self-dealing, which includes accepting preferred investment funds on terms that are different from those offered to limited liability companies.

The main risk for investors and venture capitalists is the possibility of not receiving their money back. Therefore, for the venture capital industry to expand, a solid exit strategy is essential. In addition to that. Exit mechanisms are also important for entrepreneurs. First off, the exit mechanism offers managers a financial incentive to put in extra effort for the business in exchange for equity

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compensation. The second reason is that venture capitalists give up control when the IPO occurs. According to Black and Gilson in 1998, exit mechanisms can provide management call options on the company's ownership [5]. A surge in IPOs should favorably impact the demand and supply of venture capital funds, according to research from 2016 by Gompers et al statistical [2]. The availability of an exit strategy boosts entrepreneurs' motivation to start a business on the demand side. Larger investors that believe they can recover their investment through an IPO are also willing on the supply side.

2.7. Internal Organization of Start-up

Understanding the internal structure may help to identify whether investment objectives have an impact on performance and decision-making. The average VC firm employs 14 workers, according to data from Gompers et al. from 2016. 60% of venture capital funds with partners specialize in various duties, according to a poll on the level of specialization in the industry [2]. Kaplan and Stromberg found in 2000 that venture firms were more likely to succeed if they improved their management teams [6]. Rajan and Zingales proposed a model for the optimal organizational level of a startup. In their model, companies ideally start with a few layers of architecture to minimize the risk of ideas being appropriated by employees, adding more layers over time as employees make sunk investments in the company [7]. As a result, most innovative companies have a flat management structure.

Research shows that entrepreneur criteria far outweighs other criteria such as product/service, market condition, and financial condition. Birley and Westhead found no evidence that new businesses founded by experienced founders have any advantage over their less experienced counterparts [8]. According to Shane and Stuart's findings in 2002, the amount of management experience for the preceding business held the most important influence on performance and had no discernible effect on the longevity of the business or the performance differences between the two types of entrepreneurs [9]. But Delmar and Shane found that founders' entrepreneurial experience improved the viability of new ventures and increased sales [10].

2.8. Relationships

VCs strongly believe that relationships with limited partners depend on absolute rather than relative performance. Sahlman and Jensen discovered that venture investors carry out thorough initial prohibitionism examinations of fledgling businesses to address the issue of corporate governance and oversight [11]. And they maintain some close ties through frequent visits and conversations with company management. According to Hsu, entrepreneurs prefer to raise money from VCs with better mentoring skills because they expect this help to translate into better company performance [12].

The social characteristics of entrepreneurs, such as their charm, social abilities, and capacity to get both market- and non-market benefits from their contacts with others, were characterized by Glaeser et al. as social capital [13]. According to Arrow, social contacts are a crucial economic lubricant, a valuable source for hiring qualified executives and specialists, and they can help fledgling enterprises get off the ground [14]. So a founder's relationship with VC resources can help the company get financial resources or top talent. And the entrepreneur's social relationships with former customers and suppliers can be an advantage.

3. Conclusion

When Comparing the relative importance of trading sources investment options and value-added. Value-adding factors accounted for 40 percent, while source and choice accounted for 60 percent. Transaction selection is the second of the three important additions to value, and transaction flow is

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the last. The study shows that 92% of VC firms consider the team to be crucial. Luck and timing are also important. According to the data providing by, 18% of VCs rated these two factors as the most important determinants of success. Californian VCs consider themselves more dependent on luck than VCs elsewhere.

This article explores eight perspectives that venture capitalists will consider when making investment decisions in the 20th and 21st centuries. The findings first demonstrate that venture capitalists (VCs) contribute to value creation through deal sourcing, transaction selection, and post-investment accretion. But for the sample, the trading choice is the most important of the three. Second, the team is a major player in venture capital. VC firms prioritize management teams when making investments above business-related characteristics like products and technology. The team is more important to the success of an investment than the business. In general, VCs like to look at investment decisions from a rider's perspective. Third, there is little evidence that VC firms use NPV or DCF for valuation, and VC firms rely more on internal rates of return. Quite a few venture capital firms do not forecast cash flow at all. However, the use of IRR also has certain defects. It cannot be ruled out that some company managers use IRR-related performance incentives to deliberately improve IRR and make decisions that are detrimental to startups in the long run. Fourth, the company will set up reasonable terms, and most of the terms are conducive to the investor's control over the board seats of the invested company. The terms that can be adjusted later are limited to bonuses or money-related terms, but the most difficult ones are related to shares and control of the company. Fifth, IPO is the most popular exit method for venture capital firms, where investors can access the market's investment and regain control of the company. Investors can get their money back by investing money and profits. Sixth, the characteristics of the entrepreneur are the most important factor in the internal organization. Most start-ups are advised to use less of a corporate hierarchy and be flat. Gradually add layers as the company grows and scales effectively. Experienced entrepreneurs tend to bring in greater sales and talent. And experienced entrepreneurs with better connections to the industry can bring in more effective income. Entrepreneurs with good social connections can reduce costs and increase convenience for start-ups.

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