

WHY IS IT SO HARD TO GET VENTURE CAPITAL?

By Dr Ed Hudson

A recent review of the current research on how venture capitalists make their investment decisions suggests that the decision-making process adopted by venture capitalists is more an art than a science. The review also highlights the fact that researchers have not been able to identify the key decision-making variables that lead to making a successful investment choice. Nor do venture capitalists understand their own decision-making process.

Venture Capital (VC) is usually defined as an independently managed, dedicated pool of capital that focuses on equity or equity-linked investments in privately held, high growth companies. The initial interest of researchers was in finding out what evaluation criteria were being used by venture capitalists (VCs) evaluating investment opportunities. They were interested because it was thought that VCs were successful at picking winners. Research in VC is relatively new and was initiated by researchers on the assumption that VCs have been very successful at picking winners and therefore knowing the secrets of success would be advantageous.

The original research proved promising in that a number of evaluation criteria were identified that appeared to be key determinants on how VCs make a successful investment decision. One of the first undertaken was by Wells in 1974 and Poindexter in 1976 followed ten years later by a detailed study by Tyebjee & Bruno in 1984. Since then, a number of follow-on studies have been undertaken to overcome some of the limitations identified in the earlier studies with the aim of improving the reliability and validity of the research results.

The earlier research did not examine the decision making process adequately but rather the criteria used in the evaluation process, how the evaluation criteria was applied and what weighting was being given to the criteria by respondents. Concerns began to be raised about the methodology used in these surveys and how they may be addressed. Especially when the methodologies were attempting to model human decision-making. Human decision making includes among other things, perceptions, emotions and cognitive processes which researchers have continually found difficult to model.

In addition to this, there was the inherent assumption that VCs were homogeneous in their approach to decision-making. Research showed that this was not the case and that individual VCs had unique perceptions on risk and unique views on how they evaluated investment opportunities. This proved difficult as research results could not be generalised without taking into account differences within the VC industry.

These problems meant that researchers could not replicate previous research findings. In fact, continued research into VCs decision-making showed a low convergence of the evaluation criteria used by VCs. Table 1 summarises the various evaluation criteria used by VCs as identified by previous researchers.

Only six factors; (1) management skill and experience; (2) the venture team; (3) product attributes; (4) market size; (5) market growth; and (6) expected ROI, had 50% or more of the eight studies agreeing. This has led some researchers concluding that VC is more an art than a science.

Additional criteria was suggested as being important to those stated in Table 1, namely founder's experience, competitive conditions, market share and business strategy. Incorporating these additional elements into a VC's evaluation process results in an approximation to Porter's Industry Competitive

Model. This suggests that VCs use Porter's Industry Competitive Model or a similar construct in the evaluation process.

A brief look at Table 1 clearly shows that financing or finance information does not play an important role in the VC decision-making process. However, these researchers acknowledged that VCs were concerned with the trade off between a venture's risk and return. One of the key findings made by later researchers was that financing ability played a far greater role than previously perceived by VCs and ranked higher than identified in previous research. This variable, financing ability, has consistently been identified as a less important evaluation variable in the previous studies. Which appears to be illogical considering the fact that VC is all about investing in order to make a capital gain. The omission of financing from the decision criteria concerned some researchers.

Research has concluded that in most cases, relying on VC's self-reporting on how they make their investment decisions and what criteria they use has been inaccurate. This has resulted in researchers concluding that Venture Capitalists have limited insight into their own decision making and are poor predictors of investment outcomes. Which is a result diametrically opposed to the underlying assumption that initiated research into identifying the criteria used by VCs in their investment decision-making process.

VC's screen and assess investment opportunities very rapidly reaching a Go/No Go decision in an average period of less than 6 minutes and less than 21 minutes on proposal assessment. Clearly, VCs require an effective and efficient screening and evaluation process given the number of proposals that they may review each year. Furthermore, the success rate of VCs is significantly better than the success rate of new ventures in general. This suggests that in general VCs do have an effective and efficient screening and evaluation process. To obtain this wisdom requires the examination of VC's decision-making processes rather than simply identifying the evaluation criteria used by them.

It may therefore be hard to model VC decision-making processes and to identify a general set of evaluation criteria. Some researchers concluded that VCs understanding of their actual decision-making processes was very poor.

Venture Capitalist's investment ratios vary between 1.46 percent and 3.4 percent, which implies that applications have a very small chance of successfully obtaining the necessary finance.

The rejection occurs at the initial screening stage or at the valuation stage. Reasons for rejection are different for each stage. At the screening stage rejection can occur if the proposal fails on only one criterion (fatal flaw). The decision making process of VCs can be broken into two distinct parts, Screening and Evaluation. This Screening process focuses on a small subset criteria which is non-compensatory ie an unacceptable value on one criteria cannot be offset by a higher value on another.

The criteria used in the screening stage are; market size and potential growth, a significant competitive advantage, uniqueness of the product/service, management team, funding requirement, investment stage, the industry, profit potential and economic return. One study showed that 87.5% of rejected proposals were rejected at the screening and first meeting stages.

The evaluation stage (due diligence) does allow for compensatory rules to be applied ie a low score on one decision variable can be offset by a higher score on another. The important criteria used in this stage is the same as that for screening but with less subjectivity, a greater degree of in depth analysis and a greater concentration on the financial aspects of the proposal's financials. Approximately 12.5% of rejected proposals are rejected at this stage.

Table 1
Comparison of Venture Capital Evaluation Criteria

Evaluation Criteria	Wells (1974)	Poindexter (1976)	Tyebjee and runo (1984) Phone Survey and Questionnaire	MacMillam et. al. (1985)	MacMillam et. al. (1987)	Robinson (1987)	Timmons Et. al. (1987) Unstructured Interviews	Hall and Hofer (1993) Verbal Protocols
Methodology	Personal Interviews	Questionnaire	Questionnaire	Questionnaire	Questionnaire	Questionnaire	Questionnaire	Questionnaire
Sample Size	8	97	87	100	67	53	47	16
Characteristics of the Entrepreneur								
- Management Skill and Experience	X	X	X	X	X	X	X	X
- Venture Team				X	X	X		X
- Management Stake in Firm		X	X					
- Personal Motivation	X					X		
- Entrepreneur Personality				X				
Product/Service Characteristics								
- Product Attributes	X		X	X	X			
- Product Differentiation			X				X	
- Proprietary	X			X	X			
- Growth Potential			X					
- Market Acceptance				X			X	
- Prototype				X				
Market Characteristics								
- Market Size	X		X				X	X
- Market Growth	X		X	X	X	X	X	
- Barriers to Entry			X				X	
- Competitive Threat				X	X		X	
- Venture Creates New Market				X				
Financial Characteristics								
- Cash-out Method	X		X					X
- Expected ROI		X	X	X			X	
- Expected Risk		X						
- Percentage of Equity		X						
- Investor Provisions		X						
- Size of Investment	X	X						
- Liquidity				X	X	X		
OTHER								
- References	X					X		
- Venture Investment Stage	X	X	X					
- Venture Capitalist Criteria								X

Source: Zacharakis and Meyer (1998) A lack of insight: Do venture capitalists really understand their own decision process, Journal of Business Venturing, (13) Table 1 p6

A further complication noted by researchers is that what a VC firm states as its decision-making policy is not necessarily followed by them or their analysts. This is an experience that many entrepreneurs seeking finance from VCs have had. This makes it difficult for entrepreneurs to target their presentations on those attributes VCs say they use in assessing new ventures. What criteria VCs say they use and what they actually do use are quite different.

In summary, empirical research has concluded that Venture Capitalists do not fully understand their own decision making process. There is documented evidence where a proposal was previously rejected by a VC who subsequently approved it when it was presented again without any changes being made to the original proposal.

There does not appear to be any general agreement on decision criteria used by VCs in evaluating investment proposals. This has led some researchers to conclude that each VC needs to be approached independently addressing their unique investment criteria.

Entrepreneurs targeting their presentations specifically on the criteria claimed to be used by a VC will not guarantee a positive response. The implication is that the entrepreneur should choose potential equity partners carefully. It would be worthwhile contacting existing investee companies of a VC to understand how the VC targeted evaluates investment proposals.

VCs spend a very short time on the initial review of a proposal (screening process) which averages six minutes per proposal. This suggests that those seeking finance from VCs must be able to get VC's attention within a very short period of time. Entrepreneurs who take time in preparing a succinct well worded and formatted proposal should have a better chance of getting their proposal to the next stage.

VCs will reject a proposal at the screening stage if it has a fatal flaw. They do not take into account the degree of the flaw being offset by a comparative strength in another criterion (non-compensatory process). This is relaxed if the proposal gets to the evaluation stage where compensatory processes are applied by the VC.

Only a very small proportion of investment proposals (1.4% - 3.4%) presented to VCs actually receive the requested funding.

Michael Porter's five forces model for competitive advantage may be the best model to adopt by entrepreneurs in developing their investment proposals and business plans for presentation to potential VCs.

Without a model or theoretical framework from which to underpin the application for equity funds from VCs, entrepreneurs should be mindful of the fact that VC is more an art than a science and maybe VCs prefer it that way.

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