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Venture Capital Investment Success: A Study of the Factors that Matter

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Abstract: Venture capital funding is essential for emerging businesses because it allows them to gain access to capital and other resources necessary for growth. VC firms play an important role in economic growth because they inspire innovative thinking and provide funding for startups to develop marketable products and cutting-edge technologies. Consequently, it is essential for venture capitalists to take into consideration relevant aspects before investing in order to increase the proportion of investments that are successful. Through literature analysis which has revealed that there are six key components to a successful venture capital firm: the team, the syndication, the valuation, the value-add, the interaction with investors, and the exits. Importantly, venture capitalists place more weight on the selection of transactions than on the selection of investments. Rather than considering a company's track record or product offerings, investors will place greater emphasis on the management team behind the venture. Many venture investors subscribe to the old adage that investing in a mediocre idea with excellent management is better than a fantastic business strategy with inexperienced management because a team with competent and experienced employees will play a significant part in the firm's growth. Even while it's crucial to choose your transactions carefully, value can also be created by the addition of new elements after an investment has been made.

Keywords: venture capitalists, management team, startup valuation

1. Introduction

With the formation of the first two venture firms, American Research and Development Corporation (ARDC) and J.H. Whitney & Company (JHW), the era of what are now considered to be genuine private equity investments began to develop following World War II. As the first major venture capital success story, ARDC's $70,000 investment in Digital Equipment Corporation in 1957 s often cited as an example, and by the time DEC went public in 1968, its investment return had surpassed 500 times its initial investment [1]. In recent years, venture capital has grown into a major financial market middleman, providing access to money for start-ups that might otherwise struggle to do so, and Venture capital firms provide the funding for such high-risk projects, typically by acquiring equity or equity-linked holdings privately held businesses [2].

It has been both a prosperous and trying era for venture capitalists during the previous two decades. A vast number of service firms, such as Staples, Starbucks, and TCBY, also attracted venture financing in the 1980s and 1990s, alongside many of the most successful high-tech companies including Apple Computer, Cisco Systems, Genentech, Microsoft, Netscape, and Sun Microsystems; Yet from

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1987 to 1991, fund-raising efforts dropped significantly, this was clearly because of the arrival of inexperienced venture capitalists into the market and making investors dissatisfied with the returns on their initial investments; The unprecedented uptick in activity in the late 1990s, led by companies like eBay and Yahoo!, has piqued the curiosity of many CEOs who are hoping to reap the benefits of the publicity surrounding successful venture capital investments in the 1960s and 1980s [2]. Another major contributor to businesses' growing enthusiasm for VC funding is the meteoric rise of the Internet, when the Internet boomed in the mid-1990s, the industry's competitive landscape shifted once more, and many new entrants entered the market and falsely believe to be "venture capitalists" while lacking the same level of technical and management expertise as truly VCs and being unfamiliar with the concept of managing financial portfolios. However, truly qualified venture capitalists play a significant role in guiding the strategic direction of the company and helping to develop its human capital.

This paper, with the use of literature research and review, can better understand the actions of VCs and the possible reasons for their success by investigating the importance of six aspects of investment: team, syndication, valuation, value-added, interaction with investors, and exits. VCs place the greatest importance on the management or founding team, it was by far the most significant factor identified, both for successes (96% of respondents) and failures (92%). In a study of venture capitalists, Lerner showed that over 70% mentioned the importance of complementary knowledge, capital restrictions, and risk sharing in making decisions as a syndicate [3]. For late-stage investors, valuation is more crucial, both as a consideration and as the primary consideration. According to research by Gompers et al., private equity investors rarely utilize NPV methodologies, instead favoring IRR and multiples as their primary metrics for assessing investments.

Eighty-four percent of VCs surveyed said that post-investment value-added was critical, undoubtedly, the contribution of VC to the company is inextricable from the value generated after investment. It has been suggested, both by research and anecdote, that VCs play a substantial role in the administration of the companies in their portfolios, holding regular meetings with the companies' management and advising on key personnel and strategy choices. Additionally, learning how the company is structured on the inside can also shed light on whether investment priorities have an impact on decision-making and output. Making connections with other investors is vital for those who invest in start-ups at an early stage, so the relationship between VC and investors is worth considering deeply. Since venture capitalists invest in private companies through funds that are normally structured as 10-year instruments, they are only eligible to receive a portion of the profits upon the capital's return to investors. Hence, the success of venture capital depends heavily on the timing and nature of the exit.

Finally, the venture capital sector has been evolving swiftly with other industries and the advancement of technology. While California VC firms place a high premium on a founder's enthusiasm for their work, others place it among the low priorities for potential investments. In contrast to other types of venture capital investments, healthcare venture capital has valued industry experience over passion as the most crucial attribute when making investments. Hence, while it is possible to make pertinent conclusions from examining the principles of venture capital in the last few years and today, there may be unstable aspects regarding whether future development would follow such findings.

The paper proceeds as follows. Section 2 reviews the management team. Section 3 reviews the syndication. Section 4 reviews the valuation. Section 5 reviews the post-investment value-added. Section 6 reviews the interaction with investors. Section 7 reviews the exits. Section 8 concludes.

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2. Management Team

It is widely acknowledged that one of the most essential factors in achieving success in the venture capital market is the capacity to produce a pipeline of high-quality investment opportunities or proprietary deal flow. Sørensen claims that transaction sourcing and selection account for 60% of the value created by venture capital, while the value added by venture capitalists is only 40% [4]. Therefore, for all groups, but especially for the high IPO enterprises, the selection is rated as the most crucial of all possible considerations.

Moreover, venture capital firms evaluate potential investments based on several criteria, including market attractiveness, strategy, technology, products or services, competition, transactions, and the quality and expertise of management teams. When it comes to venture capitalists, the team is by far the most significant criterion, regardless of whether the venture is successful (96% of venture capitalists) or not (92% of venture capitalists) [1]. Among all criteria, the management team is a crucial component, it is cited by 95% of VC firms as a critical success factor, followed by the business model (83%), the product (74%), the market (68%), and the industry (31%).

Meanwhile, Bernstein, Korteweg, and Laws all agree that teams are more essential than businesses when determining an investment's eventual success or failure and that investors are more likely to take the viewpoint of the team into account when making investment decisions [5]. Moreover, Hellmann and Puri concentrate on the process of how founding teams are assembled as well as the allure of such teams as investment prospects [6]. Whether it comes to becoming an early-stage investor or an IT investor, having a strong team is the single most crucial component and the healthcare industry is the only one that did not overwhelmingly identify the team as the most significant element, which is more likely to rank business-related aspects as most important [1].

3. Syndication

The venture capital screening process can be sped up with the help of syndication, and related businesses can pool their resources to make joint investments. When the initial investment has been made, venture capital firms can contribute a wealth of industry expertise to the company that was founded by the entrepreneur [7]. This is also the result of venture capital firms connecting with founders through networking. Hochberg et al. posit a variety of factors, including investors' financial limits, the need for a diversified portfolio, and the desire to share risk, as driving factors in the popularity of syndication [8].

Gompers stated that most VC firms find their funding through limited partnerships; However, the short life period of these partnerships means that VC firms need to regularly undergo extensive recapitalization by forming new limited partnerships, a process that can be challenging for startups in the VC industry [9]. Correspondingly, the data shows that on average, 65% of VC firms invest jointly, with early-stage VC firms and healthcare VC firms being more likely to do so [1].

Among all reasons for syndicating with other VCs, one of the most important considerations for many sectors is the allocation of risks, nevertheless, it is expected that the healthcare sector will place a greater emphasis on risk sharing than sectors like information technology. Although its primary objective is to strengthen the firm's standing so that it can take part in future deals, just 29% of VC firms give this factor much value.

4. Valuation

To assess a company's viability for investment, venture capitalists do a valuation, which is essentially a computation of its enterprise value [10]. Private equity investors favor internal rate of return (IRR) and multiples of invested capital (multiple) over discounted cash flow (DCF), as shown by Gompers et al. [11]. The survey and data show that cash-to-cash multiples (used by 63% of the sample) and

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internal rate of return (used by 42%) are the most common approaches, but only 22% of people who invest in start-ups use the net present value method [1]. Nevertheless, nearly half of the VCs particularly early-stage, IT, and small VCs admit that they regularly make risky investments.

Nevertheless, studies show that portfolio companies that are managed by reputed VCs tend to have better outcomes, including a more collaborative commercialization strategy and a higher probability of an initial public offering [12]. The average valuation for Ventures typically commands larger in the later stages of development, those in the technology sector, and those based in expensive regions like California, and Massachusetts, the frequency of delayed IPOs has a similarly beneficial influence on VC valuations, and the same can be said for the lagged fund flow [13].

5. Post-Investment Value-Added

Hellmann and Puri state that VCs play a crucial role in helping new businesses achieve a high level of professionalism [6]. They have the incentive to raise the company's managed capital by launching large follow-up funds because they are normally compensated with a fixed fee pay-out based on 2% to 3% of the size of assets under management and 20% of the fund's investment returns [9]. Gompers and Lerner show that the present value of annual fees is typically comparable to the present value of earnings [14]. Comparatively, open market fund managers' charge fees were four to six times as high as this one [15].

This can be traced back to the way in which venture capital firms have shaped board structures to facilitate greater organizational growth, Bartlett illustrates that venture capitalists give value to their portfolio firms by providing a variety of services, such as strategic guidance following an investment (87% of the time), customer introductions (69% of the time), operational guidance (60% of the time), board member and staff recruitment (58%) and salary negotiation (46% of the time), about two-thirds of VCs report weekly or more frequent contact with their portfolio businesses [1].

TechStars claims that a valuable network is among the most valuable assets a VC can provide to its portfolio firms. Firstly, VCs prioritize regular communication to proactively sustain and grow their existing network of contacts. Secondly, Hinds states that VC firms can actively engage in new connections and community events to properly implement their online growth strategy [16]. Moreover, it is crucial for VC firms and their portfolio companies to keep tabs on the development of their ties and networks, the top venture capitalists always think strategically about how they might leverage their contacts to assist their portfolio firms.

6. Interaction with Investors

For early-stage investors, relationship-building with other investors is particularly crucial. It's possible that both early VC firms and California VC firms can aid companies in their search for new personnel, and California VC firms are also more actively engaged in assisting their personnel recruitment in locating new counterparts and clients [1]. Perhaps this is because they operate in a cluster-like setting that facilitates a more cohesive flow of resources across their ecosystems. In addition, a large percentage (87%) of VC firms provide strategic counsel to their portfolio companies by serving on the boards of directors or as observers, and the majority (72%) of VC firms aid their portfolio companies in forming ties with investors for subsequent funding rounds. Sixty-nine percent of VCs said they assisted companies in building relationships with clients, and 65 percent said they offered operationally advise [1].

Moreover, venture partners are increasingly common at healthcare VC firms, possibly because investments in the healthcare and biotechnology industries require specialized knowledge that can only be provided by part-time venture partners like medical school professors. While healthcare VC

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firms have a slightly smaller board of directors than Technology VC firms, they spend significantly more time assisting start-ups.

7. Exits

The use of exit plans allows venture capitalists to anticipate and prepare for their financial outflows. Good investors always know where they will sell their gains and losses before making any kind of investment, therefore exit strategies are a crucial part of any successful trading plan. Gompers that it is beneficial for venture capital companies to achieve successful initial public offerings (IPOs) exit to develop a reputation and obtain new funding [9].

According to the findings of venture capital firms, initial public offerings account for only 15% of exits, whereas mergers and acquisitions account for 53%, and failures account for 32%. Since many mergers and acquisitions in the venture capital industry are failures in disguise, it is possible that merger and acquisition data is not a reliable measure of success [1]. Further, three-quarters of successful transactions, according to some VC firms, were ultimately closed via purchase rather than an initial public offering. However, individual VCs report wildly varying investment outcomes, with around a quarter losing money and nearly 10% gaining ten times as much as their initial investment. But so far, the recent performance of the IPO market has had a stronger impact on the financing volume, providing young VC firms with greater drive and allowing companies to go public sooner. Moreover, IPOs and trade sales (i.e., the complete selling of the company to strategic buyers) have historically been the preferred exit mechanism in Europe and have taken on this role in the United States [17]. Among all exits in the US VC business, only 10%-20% have been initial public offerings (IPOs) since 2001, while 80%-90% have been trading sales [18]. Consequently, exit concerns are more relevant at the later stage, this may be because the type of exit is easier to forecast in the later stage, the IPO market can also give young VC firms an additional incentive to go public sooner.

8. Conclusion

This paper explores the activities of VCs and the factors contributing to their success to learn from their strategies. we can know how to affect the overall success of venture capital companies through the literature analysis and these six aspects: the team, syndication, valuation, value-add, interaction with investors, and exits. Investment selection is the most crucial aspect of this whole process.

While the capacity to generate high-quality investment opportunities or proprietary transaction flows is seen as a key factor in the success of the venture capital sector, the team is the most critical feature that has been recognized thus far by venture capital firms in selecting related venture capital transactions. But in some interdisciplinary fields, other concerns take precedence. Expertise reserves are seen as more vital in some fields than others, such as healthcare and information technology, whereas personal connections and location are given less weight. In the healthcare industry, products, and technology are more important than location. Additionally, the expansion of the Internet has provided venture capitalists with more options when looking for investments. To improve the number of high-quality prospects that can be screened and the likelihood of investment success, the network plays a significant role in this procedure, this generating deal flow serves as the foundation for the follow-up factors: value-add, interaction with investors, and exits.

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