

Uncovering Knowledge Structures of Venture Capital Investment Decision Making

Office of Advocacy Working Paper

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Purpose

Entrepreneurs constantly seek capital for new and existing ventures although they face considerable constraints in obtaining financing. Venture capital from outside investors has been considered an important driver in the startup and growth of entrepreneurial firms. Understanding the specific investment criteria for venture capital funding is of foremost importance, since this may substantially improve these firms' chances of acquiring funding. The authors have chosen to predict funding by measuring the decisions on both funded and unfunded business plans.

Overall Findings

The study posits that venture capitalists (VCs) may be willing to fund a marginal team with better venture potential than a good venture team with limited venture potential. In other words, entrepreneurs need not only to assemble an effective team, but also to clearly demonstrate the venture potential of their proposed business. This finding contrasts with most prior studies, which identify the venture team as the key funding criterion.

Highlights

- The findings suggest that while a venture team's composition and ability are a minimum requirement

in the consideration of a venture capital investment and a major factor in explaining why a business plan gets rejected, these features are not significant in explaining why a business plan gets funded.

- The study implies that venture potential is a better indicator of business plan funding than venture team quality and that VCs have similar knowledge structures and preferences when it comes to funding and not funding actual business plans.

- The researchers analyzed the relationship between rates of return and factors such as venture team quality and venture potential. The analysis finds that a good venture team has decreasing returns even for funded ventures, but favorable competitive conditions and market potential of a business plan have increasing returns.

Scope and Methodology

The authors of this study examined both funded and unfunded business plans to determine the key factors in the venture capital investment decision process. The 2004 sample originally consisted of 200 business plans from venture capitalists that had invested as individuals. Of these business plans, 72 were funded and 128 were not funded. To increase the reliability of the study and obtain equal sized samples, 72 of the 128 unfunded plans were randomly selected. Also, steps were taken to generalize and improve the understanding of the latent decision process used across the United States. This involved obtaining business plans from the East and West Coasts. In a control for industry, business plans only from high technology firms were examined for the year studied.

Analysis was performed in three steps. First, a set of attributes meaningful to VCs was identi-

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fied using an adapted version of free-listing and focus group sessions. Second, a group of experts was asked to evaluate a set of business plans using the identified attributes. Finally, a Bayesian model was used to measure the decision factors that were identified and to predict the VCs' decisions with respect to funding the business plans.

This report was peer reviewed consistent with the Office of Advocacy's data quality guidelines. More information on this process can be obtained by contacting the director of economic research at advocacy@sba.gov or (202) 205-6533.

Ordering Information

The full text of this report and summaries of other studies performed under contract with the U.S. Small Business Administration's Office of Advocacy are available on the Internet at www.sba.gov/advo/research. Copies are available for purchase from:

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