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**What venture capitalists bet on**

by Bart van Deventer and Chipso Mlambo

**South African entrepreneurs who enter the race for project financing should take note of the criteria venture capitalists use when deciding whether to back a business or not.**

People with entrepreneurial flair usually play around with novel business schemes, sometimes hitting what they feel is the jackpot idea. With limited means and the help of close friends or family, they pursue their concept to a point where it starts to show evidence of the tremendous potential they envisage.

But since most cash available to them has by now been depleted, the only way to go forward and grow a business around the idea is to obtain a substantial injection of capital. This is where venture capitalists come into the picture. They have to be similarly convinced of the potential of this business before they will invest. No one is prepared to gamble money away on every horse touted by its owner as a winner.

Entrepreneurs need to keep in mind that venture capitalists receive many more applications than they can invest in. Moreover, most venture capitalists will have lost some investments along the way. Because venture capital investment is by nature risky, investors will do everything in their power to assess the gamble they take. And to compensate themselves for the risks they are exposed to, they will closely assess the upside potential of their investments to make sure they get commensurate returns.

Often entrepreneurs focus only on their own idea – the technological or market innovation – and its potential to generate wealth. At the stage where they need capital, however, they suddenly have to face investors who come in cold and view the prospects through their own critical lenses.

What are the assessment criteria venture capitalists use to screen the businesses of applicants, and which do they deem the most important? What should entrepreneurs take into account when they develop their business ideas and realise that they will soon need a capital injection?

To enhance the insight of entrepreneurs in this regard, research at the University of Stellenbosch Business School (USB) sought answers to these questions by surveying venture capitalist institutions in South Africa. The findings show that when these investors consider placing their bets, they will look at the jockey first, followed closely by an assessment of the horse and the race, and how much the prize money is likely to be. Venture capitalists will only invest if they trust the entrepreneur and have faith in the person's dedication and ability. In addition, the product must be a winner, the market lucrative, and the expected return on investment exceptional.

**The venture capital industry**

Venture capital exists because an entrepreneur with a new idea or product often has no other institution to turn to. The industry fills an important gap in the funding of innovation, which is otherwise mainly done by corporations, government bodies and, in a limited way, family and friends of entrepreneurs. Conventional sources of finance, such as banks, provide debt mainly to going concerns.

Investors are attracted to the venture capital industry because of the potential of super returns that more than offset their occasional losses. Consequently, they will seek out highly promising innovations and invest equity in order to make huge capital profits later when the earnings of the new business suddenly take off.

**How do venture capitalists place their bets?**

The investment process typically involves five steps. The first step is deal origination, where the venture capitalist becomes aware of the potential investment. This deal then passes through a screening process, where it is sifted along with other potential investments. The third step is the evaluation process, where the viability of each deal that has passed screening is carefully examined. If it survives the examination, the investment transaction is negotiated and structured. Lastly, certain post-investment mechanisms are put in place to protect the investment and assist in managing the business.

The rigorous evaluation process involves both quantitative and qualitative assessment procedures. The quantitative evaluation will examine the figures, for instance market projections, sales projections, costing data, and production efficiencies and capacities. Given the short business history, however, the value one

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can place on such figures is limited. Accordingly, a qualitative investigation is vital. This will focus more on the qualities of the entrepreneur and management as well as on the nature of the business environment. Strengths are usually weighed up against weaknesses.

FINDINGS FROM INTERNATIONAL RESEARCH		
International research has shown that venture capitalists view the personality and experience of the entrepreneur as one of the decisive factors. In general, their decision criteria fall into four categories: entrepreneur characteristics, product characteristics, market characteristics, and financial characteristics. One of the frequently cited theoretical models places venture capital decision criteria into five categories:		
Venture capital decision criteria		
No	Category	Description
1	Market attractiveness	Factors that depend on the existence, and size, growth and accessibility of the market
2	Product differentiation	The ability of the venture to create a unique product that can be protected by patents and will enjoy a high profit margin
3	Managerial capability	The skills of the founding team in managing several business function areas
4	Environmental threat resistance	The extent to which the venture is able to resist and deter threats from the external environment, which is influenced by factors like barriers to entry and changes in technology
5	Cash-out potential	The extent to which the venture capitalist believes that the investment can be harvested in the appropriate time frame
Model based on the article by T Tyejje and A Bruno: A model of venture capitalist investment activity, <i>Management Science</i> , 30, 1984.		

#### Venture capital in South Africa

The venture capital industry in South Africa is still in its infancy and not as strongly developed as, for example, in the United States. The private equity sphere has in recent years been dominated rather by the merger and acquisition activities of the larger corporates, with the formation of Black Economic Empowerment (BEE) companies being an important driver in this market.

According to commentators, the small number of venture capital funds operating in South Africa is unlikely to grow unless many more success stories emerge. Furthermore, the local business start-up market is characterised by a greater demand for early-stage investments – these need smaller investments, but at higher risk and smaller returns. This is not attractive territory for private equity investors, which venture capital funders typically are.

Yet, if these early phases of potential ventures are not appropriately funded, the flow of promising business concepts to the stage where they are ready for the venture capital market will remain subdued. This will tend to keep the South African venture capital industry under pressure, and makes life difficult for entrepreneurs who will struggle to find suitable investors. At the same time, venture capitalists are often flooded with applications, most of them not ready for venture capital.

The ability to steer the business side of an innovation and prepare a quality investment proposal will help the real entrepreneurs to move to the top of the application pile on the venture capitalist's desk. The goal of this particular USB research project was to alert entrepreneurs to the factors that would strengthen their chances in this regard.

#### Surveying the field

The study aimed to identify the main criteria that new ventures should comply with to succeed in obtaining venture capital funding in the South African market.

A survey was conducted among the members of the South African Venture Capital Association (SAVCA). Although SAVCA has more than 80 members, many of these are not true venture capitalists as they merely supply legal and other consultancy services to the venture capital industry. Others are more involved in hedge fund and private equity transactions, or act as investment holding companies. After an elimination process, only 16 SAVCA members were found to qualify as true venture capital investors. Questionnaires were sent to all of them, and 12 responded.

Criteria employed by venture capitalists in Europe and the USA were identified from published research in international journals and were used to construct the items for the questionnaire. In the first part of the questionnaire, respondents were asked to rank four categories of criteria – management considerations, product considerations, financial considerations and market considerations – in order of importance. The second part of the questionnaire contained an expanded list of items representing the four categories. Respondents were asked to rate the importance placed on each item in their decision processes on a scale of 1 to 5.

#### Answers from practice

##### Management considerations in top spot

The first test viewed the order of importance in which the four categories of criteria were ranked; a four was awarded to the most important and a one to the least important. The results are shown in the table below:

### Relative importance of categories

Category	Mean
Management considerations	3.3333
Product considerations	2.2500
Financial considerations	2.4167
Market considerations	2.0000

Management considerations are by far the most important, followed by product and financial considerations almost on a tie, and then market considerations. This may be counterintuitive to many entrepreneurs. They may approach a venture capitalist thinking that the new product idea, the ready market, and the profit potential will swing the deal. But the venture capitalists will most likely start by examining who is behind this idea. The question they want to have answered first is whether the entrepreneur and the management team have the capacity to turn this idea and its market potential into a successful business.

#### The entrepreneur swings the scales

The second part of the analysis focused on the items that obtained the highest ratings on the scale of importance. The table below shows those deemed most important by venture capitalists, with the category to which each item belongs indicated in the right-hand column.

MOST IMPORTANT ITEMS		
Criterion	Mean	Category
The entrepreneur is honest and has integrity	4.9091	Management considerations
A good market acceptance for the product or service is expected	4.9091	Product considerations
The venture will provide a high internal rate of return (IRR)	4.9091	Financial considerations
There is a market need for the product or service	4.8182	Market considerations
The entrepreneur has a great desire for success	4.7273	Management considerations
The product/service has a competitive advantage over competing products	4.7273	Product considerations
The venture has high valuation projections	4.7273	Financial considerations
There is potential for market growth	4.7273	Market considerations
The venture has significant potential for earnings growth	4.6364	Financial considerations
The entrepreneur has excellent management skills/experience	4.5455	Management considerations
The entrepreneur is hardworking and flexible	4.5455	Management considerations
The entrepreneur has good leadership ability	4.4545	Management considerations

Six out of the 12 top-rated items place the spotlight on the entrepreneur. This re-emphasises the message given by the ranking of categories. The entrepreneur will be the starting point of evaluation, and it is the person's honesty and integrity that appear at the top. Still, on a par with the person's character is the need to be convinced of the product's market acceptance and a high financial return.

#### Lower on the priority list

The findings also pointed out which items had received the lowest ratings (see table below). One should not, however, interpret these items as aspects that may be totally disregarded by entrepreneurs. They will certainly be assessed, but only once the more important criteria have been met.

LEAST IMPORTANT ITEMS	
Criterion	Mean
There will be a tax benefit in financing the venture	1.9091
There will be no follow-up investment required	2.0909
The venture will require low monitoring and administration costs	2.0909
The venture has BEE status	2.3636
The venture will operate in a non-competitive industry	2.4545
The venture will require low marketing and production costs	2.6364
The venture will create a new market	2.6364
Product/service is in an early stage of life cycle	2.7273
The venture has low overall capital requirements	2.7273
The venture has production capabilities in place	2.8182

What the findings nevertheless imply is that, should the entrepreneur motivate a proposal mainly around its BEE component, or no need for top-up investment, or a market where there is little competition, or low marketing and production costs, the proposal is likely to end up in the 'rejected' basket.

#### Clear message for entrepreneurs



If one analyses the top 12 items as ranked by South African venture capitalists, the message is simple. Entrepreneurs who believe they have a winning idea, and realise they will need capital soon, should pay close attention to the following:

- **The jockey.** Venture capitalists will be most concerned about the honesty and integrity of the entrepreneur. To feel secure about their future returns, they will need to trust the person in the saddle. On top of this they will make sure that this person has a desire for success, is hard-working, has excellent management skills and experience, and shows leadership ability.
- **The horse and the race.** Venture capitalists will want pretty solid evidence that there is market acceptance for the product and that it enjoys a competitive edge. They will also want to know that there is a sufficiently strong need in the market, and that the market is in a growth phase.
- **The extent of the prize money.** Venture capitalists will want relatively strong indications of an exceptional return on investment to make their bet worthwhile. For this reason, the future valuation projections and the potential for high earnings growth will be carefully scrutinised.

*Bart van Deventer conducted this study at the University of Stellenbosch Business School (USB) as his MBA study project under the supervision of Dr Chipo Mlambo. The research report, Factors influencing venture capitalists' project financing decisions in South Africa, was presented in December 2007 and the research was subsequently published by the two authors as an article with the same title in The South African Journal of Business Management, 40(1), 2009.*


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