

# Determinants on the Successful Investment of Venture Capital

Wanling Xing \*

No.1 Middle School of Linyi Shandong, Linyi, 276002, China

\* Corresponding Author Email: shijunchao23@hhu.edu.cn

**Abstract.** A successful venture capital investment means investors put money into projects or enterprises with high risks but potentially high returns. Academic staffs have been calling for further research on relevant information about venture capital, but there is no specific research about the determined factors of successful venture capital investment in the relevant literature. This paper may make you more aware of the influencing factors of venture capital, so as to help you make more comprehensive investment decisions or inspire you to conduct in-depth research in related fields. This paper finds the conclusion mainly through searching the relevant literature on venture capital and comparing it to the investment examples of individual companies. By analyzing the advantages of investors and the positive impact to the company, the paper continuously compares and evaluate and finally find out the three determined factors that have the greatest impact on venture capital investment. These are management team, valuation and deal structure respectively. Venture capital investment is an important way for small companies to further expand their scale, and it also reflects the changing trend of the world economy to a certain extent.

**Keywords:** Venture Capital, Startup, Valuation, Deal Structure.

## 1. Introduction

In the context of economic globalization, the world is increasingly interconnected in the form of globalization of production, globalization of trade and of finance. This global tendency for firms can provide them with greater market opportunities and also, they can expand their business scope. This change allows firms to adapt market changes and continuously develop itself at the same time. However, if firms especially small firms want to generate long profit, they may should improve their business ability and competitiveness. But how can these firms find help in finance if these firms want to be listed in the capital market to take bigger market share. In this case, these firms need to raise money so that firms can generate more profits. Venture capital involves making equity investments in entrepreneurial ventures, with the primary source of capital appreciation coming from the transfer of equity once the invested enterprises reach maturity or a relatively mature stage. These enterprises are usually small and full of uncertainty, so the venture capitalists need to face high risks to provide capital but also, they can get high potential rewards during or after their investment [1]. According to William A. Sahlman's passage, the structure and governance of venture capital organizations is an effective model. This model will help organizations to adapt environment of uncertainty and asymmetric information better. Venture capital entities secure funds from individuals and institutions to support early-stage ventures. Typically, these organizations adopt either a limited partnership or limited liability company structure. In a limited partnership, the venture capital entity comprises one or more limited partners and general partners. The limited partner solely contributes capital without engaging in management, while the general partner assumes responsibility for the overall management and operation [2]. For firms, venture capital investment can provide knowledge, capital to promote the firm's innovation and technology skills, it can also take the firms away from a few unnecessary risks. In addition, with the help of the investment, the firms will get more effective business strategies and strategic planning and so on. For venture capitalists, by investing risky firms, they can obtain high returns and in the same time, through their influence within the firms, they guide and advise on the development of the firms, and in the process, they learn about the industry market and form partnerships with other investors to create business opportunities [1]. Therefore, a successful investment will benefit both the investors and the firms. However, what is the most important factor for a successful investment.

## 2. Management Team

Management team is the determined factor for a successful investment. For example, the professional degree of the team such as founder's background, team's outstanding experience, the background of the specific industries, team's cooperation ability and so on. Team's resource is another significant factor because this means a variety of investment channels, broad network resources and professional technical support. Rebecca Zabriskie examined the role of top management team human capital in venture capital. The researcher collected data on the education and work history of VC fund founders and then he used these data to test the relationship between human capital and VC fund performance. The paper mentioned 3 significant human capital ways. The first one is the measures of task- and industry-specific human capital refers to the people who already have enough experiences in venture capital industry or in the specific start-ups. These experiences allow the management team to manage the portfolio better and thus achieve more investment exits. Another human capital is industry-specific human capital. This refers to the experience of management team members in areas such as strategy and management consulting, engineering and non-venture financing. The last one measure is general human capital. It refers to team members who already have educational background in business management, such as MBA degree. The researcher found that measures of task- and industry-specific human capital predict stronger than just general human capital [3]. According to Gompers et al.'s research, they found that for venture capitalists management team is more important than other characteristics. The researcher surveyed 681 firms for 885 institutional venture capitalists to find the reason for decisions. The researchers knew information about venture capitalists' practices in terms of pre-investment screening, structures and post-investment monitoring and guidance in detail. The result of the research shows that venture capitalists invest significant resources in screening, selection and value addition. Overall, venture capitalists consider management teams to be more important for deal selection and deal outcomes. The researchers will value many aspects of the company's importance before their investment. Management team is considered one of the most important factors for a successful investment. From the passage, investors will focus on the founder's ability, industry experience, passion and team cooperation more. Nevertheless, investors will also consider factors such as a company's business model, technology, market, and industry. In general, the importance of the firms in investment is reflected in the following aspects. (1) Founders team: Investors will value founders' ability, experience, team cooperation and so on. (2) Business factors: Investors will consider factors such as the company's business model, technology, market and industry. (3) Valuation: Investors need to value the company to determine the rationality of the investment. Valuation methods and assumptions are critical for a successful investment decision. (4) Value added for investors: Investors consider the value they can create for the company, including selecting the right management team, improving the business model, and selecting the right investment timing. It is important to note that different types of investors may have different attitude of the importance of these factors, for example, early-stage investors will focus more on the management team while later investors are business models [4].

In November, 2023, the author valued a company called "to summer" in her final presentation. The company was founded in 2019 and is dedicated to researching a wide range of Chinese fragrance products. The brand started round A investment in 2019, including domestic famous enterprises such as Zhenge fund and IDG Capital, less than a year after the founding of the brand. In 2022, the company's GMV reached 2.31 billion yuan and its repurchase rate is as high as 60%. The founders of "to summer" focused on the connection with nature. They wanted to create a Chinese brand with high quality products that can bring energy to people's spiritual world. The founders' background is strong, for example, Shen Li used to be the editor for fashion magazine, and because of his unique fashion perspective, the brand innovated with new marketing ways. Liu Huipu is another important founder, he used to be the former vice president of China's first online high-end consumer platform. So, he is extremely familiar with online marketing and selling for brands. The designers for perfume like Khoon was graduated from Yale with unique aesthetics for graphic design. He also worked for many

famous artists in New York, so he gained quite a few working experiences at the same time. The founder team has accumulated friends in their own industries. This greatly helped the brand to get a lot of professional support and wide publicity. Overall, it turned out that that the brand has different aspects of outstanding people for marketing and design as well as operations. This allows the team to work clearly and maximize efficiency to get the biggest profit. Therefore, much of the success of the brand and investment depends on the management team of founders. Overall, through empirical analysis and the brand case as the author mentioned above, management team a determined factor for a successful investment.

### 3. Valuation

Due to the importance of the valuation field and the paucity of related research, academic staffs have been calling for further research on valuation. We will illustrate the importance of valuation in a successful investment. The core part of a successful valuation is its method.

From Miloud et al.'s research, they use theories in the field of strategic management to predict the start-up companies' valuation. The results suggest that valuation is affected by attractiveness of the industry, the quality of founders and top management teams, and the influence of external relationships. To be specific, when a start-up company are looking for venture capital investment, these factors as we mentioned above will influence its valuation positively. These research findings can greatly help to recognize and measure the factors that are important to valuation by providing more theoretical rigor. The researchers also mentioned that the applicability of traditional financial valuation methods is limited by the fact that these methods which rely on strict assumptions and information is generally not available from new ventures. Therefore, this method is more like "guesswork" and the uncertainty of investment may lead to investors to overvalue or undervalue startups, so that affects the success of investment. The paper also mentions an alternative approach to valuating start-ups through strategic analysis. By considering strategic theories such as industry organization economics, resource-based perspective and network theory, the value of a start-up can be estimated synthetically. This approach allows a better understanding of the valuation factors and can also provide more accurate valuation methods. Therefore, valuation methods are very important for successful investment. Accurate valuation methods can help investors avoid over-valuation or undervaluation problems, thus will improve the success rate of investment. At the same time, it not only can help to reduce potential conflicts between investors and entrepreneur, but also promote cooperative relationship [5].

D Cumming and N Dai's paper also mentioned that valuation of venture capital investment is quite different from other financial ways because the valuation of venture capital is largely determined through negotiation between the capital provider and the entrepreneur. The researchers started with OLS regressions to investigate. They found that valuation has 3 significant influences to a successful investment. (1) For VCs, their final return is related to the difference between the earnings at exit and the price at which they invested. Thus, a lower valuation implies that they are more likely to receive a higher return on exit. (2) For founders, valuation in the financing rounds determines the proportion of ownership they need to give up in order to obtain a certain amount of funding. This can directly affect the control structure of the startup. Thus, lower valuations may be more beneficial for founders. (3) Lower valuation may reflect investors' confidence because they believe that such valuations are more in line with the actual value of the company. This can help the company to get more financial funds in the progress. Overall, lower valuations may have positive effects on venture capital success, including higher returns for venture capitalists, reduced ownership percentages that entrepreneurs need to give up, and increased opportunities for follow-on financing [6].

Andreas Köhn wrote in his paper that start-up valuation in the venture capital is often said to be more art than science. He provided a systematic review of the determinants of startup valuation in the context of venture capital. He focused on each paper's key factors about start-up company valuation, and these factors were classified and integrated to form a comprehensive framework. This framework

divides the determinants of start-up valuation in the context of venture capital into three levels: the start-up level, the venture investor level, and the external environment level. This method provides a useful framework for researchers to understand determined factors better. From the paper, it is easy to find that intellectual property rights and strategic alliances are important factors to reduce information asymmetry and increasing startup valuation. For example, strategic alliances can help start-ups gain access to resources and signal the quality of the firm to investors, thereby reducing information asymmetry. By reducing information asymmetry, investors will know financial conditions, industry market and advantages of competition deeper, thus they will build confidence in the process, improve the accuracy of the investment and reduce risks [7].

To sum up, many factors of firms will have an impact on the valuation, which in turn affects the success rate of the investment.

#### 4. Deal Structure

The third determined factor is deal structure. The "deal" refers to the transaction related to venture capital. Specifically, these transactions include various activities in collaboration with entrepreneurs, such as providing funding, participating in decision making, and providing advice and support. Venture capitalists play an important role in these deals, working with entrepreneurs to determine the direction and strategy of investment and providing help and support when needed [8].

HOLLISTER B. SYKES discussed risks in venture capital and determined factors in his paper. The paper suggested that communication and cooperation between investors and the company can be better promoted by establishing business relationship such as research contracts or marketing arrangement. Appropriate deal between the company and investors can promote their communication to get each other's business opinion efficiently. In particular, the highest strategic value can be generated in terms of common interests [9].

Strat. Entrepreneurship J. 's paper also mentioned strategic value and common interests. He focused on deal approach and investment practices of corporate venture capitalists (CVC). He introduced the importance of corporation between them. Researchers had adopted several methods to obtain multi-source. First, they made 45 interviews with 23 senior CVC executives. Next, researchers use other methods such as document and expert verification to examine the interview data. Then, researchers also conducted multiple case study over 2 periods to ensure the non-replicability of the results. This way, researchers can examine reliability and accuracy of the results from different angles. From the passage, the impact of successful venture capital investment can be considered from the following aspects. 1. Reduction of information asymmetry: Venture investors often rely on referrals from referees and business partners to find investment opportunities, which can reduce information asymmetry and poor selection problems. The deal can provide more information and context, enabling venture investors to evaluate and select investment opportunities better. 2. Increased chances of success: The deal can provide unique technology capabilities and resource, so that the rate of success increased. By connecting with firms, venture capitalists can leverage firms' technological capabilities and industry experience, and provide more support and value addition, thus increasing the success probability of the projects. 3. Achievement of strategic interests. The deal will help the company to achieve strategic interests and find appropriate chance like supplier and customer relationships. 4. The chance of organizational learning: The deal can build relationship between these young companies. Therefore, investors can learn new trend of technology can market dynamics to help the company redefine their strategies. So, deal can truly make a great influence to venture capital investment [10].

The author believes during the investment, communication plays a significant role in their deal. Steier and Greenwood sited a case in their paper. The author will use this case to illustrate the communication's importance. Clean & Fresh Greens (hereafter referred to as Clean & Fresh) is a company which is targeted to be a significant producer of salad vegetables that meet the needs of the food service and retail markets. The paper mentioned the relationship between Clean & Fresh

company and venture capitalists. It said although there had some technology and capital delays problems, all parties involved remain optimistic attitude about the potential of the product. However, due to funding delays and other problems, the company was ultimately unable to achieve profitability [11]. The deal has a lot of experiences readers can learn from, for example, these venture capitalists seated on the company's board of directors and were actively involved in the company's strategic planning and operational plans. This way investors will better participate in the company's various resolutions, help the company clarify the overall plan, and constantly promote the company's upward development and the 2 side will get each other's demand correctly to cooperate better. But how to clarify the responsibilities of all parties in the cooperation to ensure that the relationship with the startup can be effectively managed? The paper points to the need to clarify the responsibilities of the venture capitalists in the partnership and designate a person who is responsible for monitoring and coordinating the activities. This ensures that the collaborative process is managed effectively and reduces the risks like capital delays faced by new ventures [11].

Overall, it is clearly that investors should clarify the deal between venture capitalists and the company to ensure the communication between the two parties, to follow up the investment steps, so as to efficiently complete the investment task. So, deal structure is a determined factor for a successful investment.

## 5. Conclusion

Above all, this paper has complied relevant empirical research of the 3 determined factors for a successful venture capital investment. Not only do these 3 factors reduce the risk of investment to a certain extent and reduce certain losses, but also help the company to grow rapidly, expand business and obtain larger profits. Promoting investment process continuously will also help investors to link the market trend and promote better cooperation opportunities in the same time. There also have other significant factors which will influence the investment greatly, the author sincerely hopes to research them deeper in the future. Lastly, by concerning management team, valuation and deal structure before or during the investment, both the 2 side are able to be benefit and this will hopefully accelerate the development of the finance, help to build a new economic order and promote further economic globalization of the world. In this regard, the illuminated paths will focus on more research on the revolution way of venture capital in the VC context for future research.

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