

# The Impact of Key Factors on the Success of Venture Capital Investment

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**Abstract.** This article analyzes the key factors that affect the investment of venture capitalists: the founding team, the startup's traction, the valuation, the deal structure, and the identity of current investors. Then we analyze the impact of various factors on investment decisions. The research results of this paper indicate that venture capitalists consider multiple factors when investing. Although all five factors in the paper are important, the founding team is the key factor determining the success of the investment. The startup's traction is also important when making the deal selection. The valuation factor will determine how much money the venture capitalist will invest. The deal structure can protect venture capitalists from extreme loss. The identity of current investors is less important but choosing a startup based on the identity of existing investors is also an effective strategy. Together, this paper shows how venture capitalists can choose startups from these five factors. Also, startups can use these results to better understand how they are valued by venture capitalists, how they attract venture capital, and what issues they should pay attention to when negotiating terms.

**Keywords:** Venture capital; entrepreneurs; founding teams; startups.

## 1. Introduction

Venture capitalists provide funds for early entrepreneurs. Research has shown that venture capitalists play an important role in allocating capital, providing capital for newly established startups to survive and continue to develop, thereby stimulating innovation and promoting economic growth. Kaplan and Strömberg believe that venture capital companies have been particularly successful in solving the principal-agent problem by connecting startups with good ideas but no funds with investors with funds but no good ideas and allocating funds appropriately [1]. Many well-known companies have been supported by venture capital, which has had a significant impact on the global economy. Startups are often characterized by uncertain prospects, high investment risk, unstable cash flow, and sufficient collateral. At the same time, investors often face serious information asymmetry problems due to insufficient information about startups. This makes it difficult for venture investors to choose their investment objectives. However, if venture capitalists invest in successful startups, the returns are often tremendous. In 2016, researchers such as Harris found that venture capitalists generally outperform the public market. These make venture investors pay more attention to the choice of startups. So, what factors affect the choice of venture capitalists?

This article will analyze five factors that venture capitalists consider when selecting startups. This would be very helpful, on the one side, it can give some insights to the practitioners engaged with the venture capital investment. On the other side, it can enrich the studies on the implementation of venture capital investment. Based on these, the following two questions are developed. What are the factors that help venture capitalists make a successful investment? How can these factors help venture capitalists make a successful investment?

Many academic studies have been conducted on the importance of venture capitalist factors that impact successful investment. This issue is referred to by many researchers as "jockey and horse", with the founding team often referred to as jockey and the business referred to as a horse. A successful startup must have a good combination of these two factors. So, what factors should venture capitalists focus on and what strategies should they adopt to distinguish successful startups?

Rajan argues that the quality of human resources is a key factor in determining the success of a startup [2]. This feature is particularly prominent when the company's early-stage experiments are very important. Researchers such as Grossman and Hart believe that non-human assets are the most critical factor, investors should actively seek out potential startups, identify signs of success, and summarize reasonable ways to invest in them [3]. Valuation is also a factor that venture capitalists need to consider. According to financial theory, investment decisions should be analyzed using DCF or NPV, and the cost of capital is based on the systematic risk of opportunity. It is found that 75% of CFOs always or almost always use this type of analysis, using it at the same frequency as internal income reporting. Kaplan and Strömberg mention that the deal structure is a key factor when venture capitalists are making decisions [1]. It is found that private equity investors mainly rely on IRR and MOIC to evaluate their investments. They rarely use the net present value method. Researchers such as Bikhchandani believe that investors often refer to the behavior of other venture capitalists to make their own judgments, rather than through their own analytical thinking. In other words, investors focus on existing investors.

This paper will introduce the five factors mentioned above: the founding team, the startup's traction, the valuation, the deal structure, and the identity of current investors.

## 2. Founding Team

The founding team or top management team (TMT) of a startup is often one of the factors that venture capitalists are most concerned about. There are many ways to define a founding team or top management team. Some people define the first people to join the company as the founding team of the company, some people define the earliest owners of the company as the founding team, some people define the people with executive titles as the founding team, and others define who will serve as an executive before a potential investment as the founding team [4]. Founders in a startup team often have specific technical or management capabilities that can play an important guiding role in the initial development of a startup. Many of the founding teams of large companies we know well often have top talent in this field. The startup team determines the quality of a startup and determines its development by influencing its organizational and management capabilities, its ability to access resources, and its innovation capabilities [5]. Many studies have defined and examined the level of education and experience of startup teams. Some studies examined industry experience, some examined entrepreneurial experience, and others examined management experience [6, 7]. When investing, venture capitalists need to fully consider these indicators of the startup team. This is difficult and requires venture capitalists to have good experience and education, and to be able to inspect startup teams through various signs.

Another aspect that venture capitalists need to consider is what they can do as investors to help startup teams. Venture capitalists can serve as mentors for startup teams, helping startups optimize their startup teams. Venture capitalists can also use their experience and resources in this field to help companies prototype and iterate on their products, validate launch plans, and establish business models, thereby helping startups achieve better development. Venture capitalists can also help startups move towards formalization and specialization, such as helping them implement stock option plans and reasonable human resources policies.

Many studies have shown that the most experienced and successful investors only respond to team information. Evidence shows that investors care about the ability of the founding team because it is an important signal of the company's condition, and a strong founding team can also improve the company's management ability [8]. This indicates that selecting based on the founding team information is a successful and feasible investment strategy.

### **3. Startup's Traction**

Venture capitalists examine the company's traction from multiple perspectives to identify signs that startups can succeed. Venture capitalists can examine the strategy and business model known as "horse" through multiple indicators. The following describes the factors that venture capitalists often pay attention to when examining a company's transactions.

#### **3.1. Registered Startups**

Registered startups are more likely to be invested by venture capitalists than companies that are not registered. As an independent legal person, a company enjoys the right to make profits and is protected by law, enabling the efficient and standardized operation of the company organization. After registration and establishment, the company can be used as the main body to apply for the protection of relevant intellectual property rights and enjoy the relevant benefits brought by intellectual property rights. Registered companies can enjoy preferential tax policies and better access to resources.

#### **3.2. Equity**

Startups with more equity are more likely to be invested by venture capitalists. Because startups often do not have sufficient collateral, the risk level of investing in startups is often high, and if the company goes bankrupt, investors will bear greater losses. A higher equity level often indicates that the lower the financial risk of a startup, the less risk the venture capitalist will bear, and therefore, a startup with higher equity will be more favored by venture capitalists.

#### **3.3. Gross Profits**

Startups with higher gross margins are more likely to be invested by venture capitalists. Gross profit reflects the result of comparing input and output in current operating activities, and to a certain extent reflects the level of economic efficiency of the enterprise. The amount of profit is closely related to the interest of the enterprise. Profit is also a factor that venture capitalists consider when investing.

#### **3.4. Turnover**

Turnover reflects the overall operating level of the enterprise. A high turnover indicates that a start-up company has good product sales, a large scale, good profitability, and strong viability. Turnover is the basis of net profit, and the higher the growth rate of operating revenue, the greater the space for converting into net profit in the future. Venture capitalists often want startups to have a high level of turnover.

#### **3.5. Synergy**

Some companies' venture capital departments also take into account the synergy between the startup and the parent company when making venture capital investments. For example, a startup may serve as a link in the parent company's supply chain to help the parent company improve its own supply chain ecology. At the same time, the parent company can also provide assistance for the development of startups, ultimately achieving a win-win situation.

#### **3.6. Potential Business Concepts**

Venture capitalists need to identify the strengths and weaknesses of a startup's business concept. The first step should be to investigate whether there are other products or services that are similar to the startup's philosophy. Even though a similar business model is found, there is no need to worry. This may simply mean that there is a strong market worth entering. In addition, startups can analyze potential competitors to determine consumer needs and guide them in optimizing their existing businesses. Startups also need to study customer feedback on the services and products they provide

and identify potential competitors. Once faced with constraints from competitors, startups need to provide solutions to create a unique product to meet differentiated needs.

If similar services and products cannot be found, this may indicate that this business concept has great development prospects and that the startup has the potential to become a successful enterprise. However, it is also likely that the implementation of this business concept is difficult. Therefore, venture investors need to use their own experience and their education level to identify and select potential business concepts.

### 3.7. Government Support

Venture capitalists need to pay attention to whether the government provides support in the industry of the start-up. Many startups are located in emerging industries which often have great development prospects, and the government will provide policy assistance to such startups in order to gain an advantageous position in emerging industries. Such enterprises have a greater likelihood of success. Therefore, venture investors also need to pay attention to government support in this field when investing.

## 4. Valuation

In school, the investment decision-making methods we learn generally include NPV analysis, IRR analysis, or DCF analysis. Graham and Harvey found that the majority (75%) of corporate CFOs always use these three types of analysis methods [9]. On the other hand, research has found that the main analysis methods for PE investors are IRR and MOIC, and the use of NPV methods is very low. So, what methods would venture capitalists choose to evaluate the value of a startup? Gompers et al. conducted interviews with multiple venture capitalists to understand the financial indicators and valuation methods used by venture capitalists when evaluating startups [6]. This is described below.

Gompers et al. investigated the importance of financial indicators such as IRR, MOIC, or NPV when venture capitalists make decisions. The statistical results show that there is a significant difference between the financial indicators used by venture capitalists and the indicators used by CFOs. Only 22% of venture capitalists use the NPV method, the MOIC method is the most popular (63%), and the IRR method is also widely used (42%). The survey results show that the financial indicators used by venture capitalists are more similar to those used by private equity investors. Although the use rate of NPV by venture investors is relatively low, the 22% use level proves that venture investors have not completely abandoned the NPV indicator, which contradicts the anecdotal evidence that venture investors rarely use the net present value method to evaluate startups. At the same time, consistent with anecdotal evidence, 9% of venture capitalists admit that they do not use any financial indicators when selecting startups, which is even more evident among early investors, with 17% of early investors not using any financial indicators. In addition, a large number of venture investors say they often make bolder investment decisions.

Venture capitalists are less likely to use financial indicators to select startups, which is quite different from what is taught in finance courses. This may be related to the characteristics of a startup. On the one hand, venture capitalists investing in start-ups will face significant information asymmetry issues. Due to the small amount of historical information about startups and the more likely lack of standardized financial information, venture capitalists are unable to determine credible financial indicators; on the other hand, the uncertainty of the future development prospects of startups also makes it very difficult to determine the future cash flow of startups, further reducing the reliability of financial indicators. In this situation, venture capitalists rely more on their own experience and educational level to make decisions, rather than relying on financial indicators.

The average IRR and MOIC levels required by venture capitalists are often higher than those required by private equity investors, while the internal rate of return required by early-stage venture capital is higher than that of late-stage and large venture capital companies. This may be because

early-stage venture capital has a higher probability of failure, and early-stage venture investors calculate the internal rate of return based on the probability of success.

## 5. Deal Structure

The complex contractual terms negotiated by venture capitalists in their investments are also key factors to consider when selecting startups. Generally, it includes cash flow clauses, control rights, liquidation rights, and employment rights. Researchers have elaborated on the content of these rights clauses and explained the role of these clauses in venture capital. Research shows that the lowest negotiable terms of venture capital companies are ranked in descending order: proportional distribution rights, liquidation priority, anti-dilution protection, valuation, board control, and ownership. The most negotiable terms for venture capital companies are dividends, redemption rights, option pools, investment amounts, and participation.

These terms are things that venture capitalists need to carefully consider when negotiating with startups. Venture capitalists need to establish reasonable terms to constrain the behavior of startups, thereby controlling the risks faced by startups and protecting their own interests from losses.

## 6. Other Investors

Venture investors can screen startups by analyzing the behavior of successful venture investors. Research has shown that successful venture capitalists are often able to use their experience and skills to choose the right startups to invest in, and this success is sustainable. The success of venture capital investors cannot be separated from their correct choice at an early stage of the startup. Therefore, screening venture capitalists based on past successful experiences and referring to their investment behavior is also a feasible investment plan.

Research by Korteweg and Sorensen shows that smaller funds have greater long-term durability than larger funds [10]. In particular, large venture capital funds have poor long-term durability. At the same time, there are differences in the performance sustainability of venture capitalists in different countries. Venture capitalists in the United States and Europe have lower performance sustainability, while companies located in other regions of the world have greater sustainability. Therefore, LPs are increasingly paying attention to collecting detailed information on the performance of venture capitalists to reduce the problem of information asymmetry, which explains why persistence does not disappear, as LPs with the ability to identify the strengths and weaknesses of venture capitalists may also be rarer and require higher returns, resulting in the long-term durability of performance persistence.

Venture capitalists also need to pay attention to the existing investors in the startup. Existing investors often have certain protective provisions, such as anti-dilution provisions, to protect their own interests from losses due to the entry of subsequent investors. At the same time, existing investors in startups can also have an impact on the operation and management of startups. Therefore, venture investors need to pay special attention to these factors when investing in startups.

## 7. Conclusion

This paper analyzes the factors that venture capitalists need to pay attention to when choosing startups. Compared to investing in listed companies, venture capitalists often face serious information issues when choosing startups. Although venture investors' investment in startups can promote social innovation and economic growth, there are significant differences between the way venture investors choose startups and traditional ways. This paper divides the factors that venture capitalists need to pay attention to when selecting startups into five points, which are: the founding team, the startup's traction, the valuation, the deal structure, and other investors. It has been found that founding team information often receives the most attention from venture capitalists, and the attractiveness of a company, that is, its current operating conditions and prospects for business concepts, also receives

the attention of venture capitalists. When valuing startups, venture capitalists rely less on financial indicators to make judgments, but rather on their own experience and skills. The transaction structure has also attracted the attention of venture investors, who need to control the risk level of startups through various terms and ensure their own interests.

Finally, we found that the successful investment of successful venture investors has a certain degree of sustainability, which means that analyzing the behavior of successful venture investors to invest in startups is also a feasible strategy. Also, venture investors need to pay attention to current investor situation. The results of this paper are not only helpful for venture capitalists, but also meaningful for entrepreneurs who need venture capital. Startups can use these results to better understand how they are valued by venture capitalists, how they attract venture capital, and what issues they should pay attention to when negotiating terms. This will enable startups to be better prepared for and have a better understanding of venture capital.

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