Venture Capitalist: The Factors of the Successful Investment

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Abstract. The venture capital industry has gradually received increasing attention in recent years. Making a successful investment is crucial for risk controllers. This paper mainly examines three factors that affect successful investment by reviewing papers in this field: founding team, valuation, and deal structure. In the factor of team formation, this article mentions five indicators that entrepreneurs and founding teams should consider when investing: learning ability, the execution of the founding team, personal traits of the entrepreneurs, network resources of the entrepreneurs, and integrity and complementarity. Venture capitalists with different experiences have different standards for project selection, and different economic environments can also have an impact on the selection of venture capital projects. By summarizing the relative valuation method and absolute valuation method, different valuation methods may lead to different conclusions. Therefore, in order to achieve a more accurate valuation, it is necessary to determine the needs and valuation methods of both investors. In the factor of deal structure, this paper reflects that trading structure is an important stage that connects the past and the future, and a successful trading structure can boost confidence and create advantages.

Keywords: Founding Team, Valuation, Deal Structure.

1 Introduction

Venture capital is a form of capital that raises funds in the form of private equity. Venture capital is usually established in companies or other organizations. From the 1950s, venture capital started accessing the public as a new investment form. From the 1970s to the 1980s, venture capital developed rapidly, with the establishment of many venture capital companies. One-third of companies that have gone public in the US had venture capital as support. Venture capital, as a high-risk, high-return, and long-term investment form, was gradually becoming a popular form of investment. Investors usually focused on investing in newly built small and medium-sized, high-tech companies in order to get a high return after the invested companies become IPOs.

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This paper will focus on venture capital in China. Considering the difficulty of collecting data on investee companies, this paper will analyze the ventral capital from the perspective of the investors. At the time period when venture capital developed fast around the world, venture capital was imported into China and soon got the support of the government. Till now, venture capital become more sophisticated, and the success rate of venture capital also increases.

There are many factors that can influence the success of venture capital. This paper will mainly cover three factors which are the founding team, valuation, and deal structure. First, we will discuss how the founding team will affect. Both domestic and international practice show that, a rational, thoughtful, and experienced founding team is possible to make better decisions on the company's investment projects, clear objectives, and direction of the company, which will reduce risks. Second, it will focus on valuation. The valuation of a firm is important information for investors because investors always want a low investment and a high return. However, for the company that needs to invest, they badly need investors to give them a certain amount of money in order to support their projects. So, valuation is always a good point of contention between the investees and investors. Finally, it will consider the deal structure. The deal structure includes but is not limited to the deal methods (assets/ equity), payment and time, trading organization, risk bearing, and exit. These provisions guarantee the benefits of both the investor and the investee. This paper extends these three areas in this paper and shows a critical discussion. How these three factors will influent the success rate of venture capital.

2 Founding Team

The founding team is one of the most important factors that venture capitalists would consider during the deal screening stage. It was first considered by Wells and Poindexter in their study of the selection criteria of venture capital projects and then became one of the determinants with the highest weight in the VC's decision-making process [1, 2]. The founding team of a startup is crucial to its success or failure. It is the team that sets the vision for the company, develops the product or service, and drives the business forward. The quality of entrepreneurs and their teams directly determines the future development of the startups. High-quality entrepreneurial teams can bring greater development to entrepreneurial enterprises, while ordinary founding teams may lead to failure. Therefore, venture capitalists place a lot of emphasis on the quality of the founding team when deciding whether or not to invest in a startup.

One reason why the founding team factor is so important is that it provides a glimpse into the startup's potential for success. A strong founding team can mitigate many risks associated with starting a new business, including market uncertainty and competition. They have the skills and experience necessary to develop a viable business plan, execute it effectively, and adapt to changing market conditions as needed. Additionally, a strong founding team will be able to attract top talent to their startup, which is essential for growth and development. On the other hand, effective leadership is crucial for driving growth, fostering innovation, and creating a positive culture within the company.

Leaders who can inspire others, make tough decisions, and maintain a clear vision for the future can help startups survive during difficult times. Leadership skills are particularly important in times of crisis when the team needs guidance and direction to navigate uncertain waters. As a result, the founding team has been one of the most important factors that need to be considered during deal screening. In a questionnaire survey done by Tyebjee and Bruno, 89% of 46 venture capitalists mentioned the importance of management skills & history, which is highly related to the founding team activities [3].

Based on previous research and combined with entrepreneur trait theory, human resource theory, and social network theory, this paper summarizes 5 indicators of entrepreneurs and the founding teams that should be examined when investing:

(1) Learning Ability: In today's era of rapid social development, technology and knowledge change with each passing day, entrepreneurs need to keep up with the pace of the times and constantly update their knowledge. Therefore, high learning ability is necessary. In the face of fierce competition, entrepreneurs' learning ability can make enterprises better adapt to the new situation, so as to be the winner in the competition.

(2) The execution of the founding team: The success of a startup needs not only brilliant ideas but also a high-executing team since all the ideas have to be realized in reality at the end. The strong execution of the team helps the business seize important opportunities they recognized and lead the startup to success.

(3) Personal traits of the entrepreneurs: Many venture capitalists investigate the entrepreneur's personal qualities, especially his or her credit when deciding whether a business is worth investing in. Those who have a low credit mark will probably not have investment, which is the same as a bank loan. Second is the sense of responsibility of the entrepreneur. Since entrepreneurship is a long-term process, after receiving investment, entrepreneurs need to operate the company dutifully and make long-term efforts for the project, which requires entrepreneurs to have a strong sense of responsibility.

(4) Network resources of the entrepreneurs: At the beginning stage of a business, entrepreneurs need support from all aspects, including capital, suppliers, customers, etc. If the entrepreneur has a broad network, it can help the enterprise to open the market faster and develop rapidly. In the special context of China, networking can also enable enterprises to do things more efficiently and solve difficulties better. As a result, venture capitalists will look into the network resources of the entrepreneurs. Sometimes, they put extra attention to entrepreneurs' educational backgrounds and experiences, since this not only equips them with an understanding of the business but also helps them form a high-quality social network.

(5) Integrity and complementarity of the entrepreneurial team: A complete team not only increases the chances of success but also saves potential investors a lot of time. The complementarity of the team can improve the efficiency of cooperation, thus bringing greater value to the enterprise. If the team is incomplete, the venture capitalist may need to assist the entrepreneur in hiring more members, which increases the cost of the venture capital [4].

This paper also looks into some famous venture capitals in China and checks whether their criteria are the same as ours. The result is shown below in Table 1. It is found that their criteria are very similar to what have concluded above.

Table 1. Venture capitals in China and their criteria.

Venture Capital	Investment Case	Criteria
SAIF Partners	58.com, Perfect World, Element Fresh	Diversity background of the team, personal traits
Draper Fisher Jurvetson	Baidu, Focus Media	Younger entrepreneur, personal traits (e.g. honesty, passion), learning ability, resources, execution ability, etc.
Sinovation Ventures	Zhihu, Renren Video, MoJi Weather	Entrepreneur's understanding of the business, anti-pressure ability, learning ability

It is worth mentioning that Venture capitalists with different experiences also have different criteria for project selection. Younger VCs usually focus more on the personal traits of individuals, while experienced VCs focus more on group cohesiveness [5]. On the other hand, Different economic system environment also has an impact on venture capitalist project selection. According to Zacharakis et al., different economic system environment also has an impact on venture capitalist project selection [6]. Compared to VCs in emerging economy (South Korea) and mature market economies (US), VCs in transitional economy (China) weigh human capital factors more heavily, which is consistent with our findings.

3 Valuation

The valuation of a company is an important indicator for the investor to decide whether it is profitable to invest in the company. However, there is always appears that a company is over-valued or under-valued, which will affect the venture capital. From the calculation, for 135 US unicorns, their post-money valuations are higher than the fair value by an average of 48%, and 14 of them are over-valued by 100% [7]. In China, Wang Ying estimated that the market in China will continuously be over-valued [8].

Before investors started to invest in a company, the investors need to value the company, and then decide whether to invest. According to a survey of the US market, it shows that, for investors, the exit consideration most important factor, followed by the comparable company valuations rank, then the desired ownership, and the competitive pressure become the last one. The survey also shows that the late-stage VC firms think the exit considerations are more important, because of the easier prediction of the shape of the exit. The late-stage firms have more information and can probably use a mature method to complete the valuation. The early-stage VC firms seem to put more concentration on ownership. Besides, the early-stage VC firms have less information, so that they have to simplify the method of valuation [9].

Valuation can be briefly separated into two methods, one is the Relative Valuation Approach, and the other is the Absolute Valuation Approach. The first method, Relative Valuation Approach, this method needs to select comparable or referenceable listed companies which are in the same industry. Then, using the stock price and financial data such as price-earnings ratio, market sales ratio(P/S), and enterprise value multiple to value the company. As mentioned before, the Chinese market will be over-valued, and Relative Valuation Approach will be affected as over-valued. For the Absolute Valuation Approach, investors more concentrate on the company's own value. The investors usually build a discount cash flow to predict the company's own cash flow and cost of capital in the future and then discount the future cash flow. The present value of the company should be the value of the company. Although this method seems more rational, it needs a lot of assumptions to get the ideal state.

Over-value can be considered that the investee companies can raise more funds to run the projects or to finish their objectives by diluting less equity. For the investors, they need to invest more money in the companies. If the company does well after being invested, and successfully gets profit, the investors can get a higher return. If not, the investors will lose more money. Under-value is when the valuation of the company is less than the company's real value, as a result, the company cannot complete the projects. The company needs to evaluate again or go for a second round of financing. Because of the long-term return and risky investment, the company will receive a higher rate of standstill or the cancellation of the projects, the investors will wait for a longer time to get the return of the money or lose them.

In order to value a company more accurately and get the result of valuation to satisfy both investee and investors, it is necessary to confirm the needs of both parties and the method to value. Because different methods may cause different results, for example, the relative valuation method will be affected by the whole market, the comparable company, and the industry performance. Some of the small VC firms do not use the financial metric when doing valuations. What's more, almost half of the VCs, especially the early-stage, IT, often use the financial metric. From this, a financial metric is a good tool that can give VC firms and investors more indicators to estimate the value of a company. In the future, venture capital will become a more popular investment form. Also, there will be more samples for us to analyze. After collecting more data both from the investee company and VC firms, we can use different valuation models to get more details and a deeper understanding of valuation.

4 Deal Structure

Structuring the deal is an important part of the investment to protect the right and interests of both the investors and investees. It means negotiating and mutually establishing a VC agreement. The deal structure provides the price that the venture capitalists will pay for the acquisition, the assets they will receive, and the liabilities they assume. As Payne, Moore & Bell mentioned that it can to some extent boost investor confidence and create advantages [10].

In the process of investment, companies should first complete due diligence and select a portfolio before negotiating and confirming the structure of the investment. For the investment instrument, it should meet both portfolio company financing and GP needs, and the deployment should be clarified, and include a strategy for the ultimate exit. When confirming the deal structure, the investment instrument should be paid special attention as the first step in deal structuring. The purpose of designing a transaction structure is to determine the status, rights, and responsibilities of both parties in the acquired company within a certain legal framework, and determine the ownership of the company's future decision-making power, thereby reducing transaction risks and ultimately achieving a win-win situation.

Regarding the principle of transaction structure, a good transaction structure is to cover all possible situations with as few clauses as possible, meets the objectives of all parties to the transaction, balances the risk-benefit relationship of all parties to the transaction, and adapts to the legal and tax environment. The basic principle followed by the transaction structure can be said to be a principle of balance. That is to say, from the perspective of the transaction structure, a balance should be achieved between the complexity of the transaction structure, transaction risks, and transaction costs; from the perspective of the parties involved, a balance should be achieved in terms of the rights, obligations, and risk bearing of both parties to the transaction.

Li divided the design of transaction structure into three aspects: the selection of financial instruments, transaction pricing and equity arrangements, and governance structure [11]. Chen once summarized in his article that when venture capital conducts transaction structure design and chooses financial instruments, it is necessary to combine the stage of the entrepreneurial enterprise, the risks and interests of venture capital, and the interests of the entrepreneurial enterprise to flexibly choose financial instruments and control investment risks [12]. Preferred shares and convertible bonds are the main types of financial instrument selection. Transaction pricing is the financial basis of equity arrangement, which is to determine the valuation of the enterprise based on bargaining between the two parties and to determine the share of venture capitalists in the equity of the invested enterprise. Governance structure arrangement is an arrangement using incentive mechanisms and restraint mechanisms to make the interests of venture capitalists, invested enterprises, and enterprise management consistent, and encourage management to work for the interests of venture capitalists, the interests of the enterprise, and the interests of the management itself. The reason why transaction structure is an important factor affecting a successful investment is that improving its rationality and compatibility with the investment object will to some extent affect investor confidence and enhance the competitive advantage of the product [10].

5 Conclusion

This article mainly focuses on the founding team, valuation, and trading structure in studying the factors that affect the success rate of venture capital. When forming a founding team, attention should be paid to the personal style of the analyst, especially these five indicators: learning ability, the executive power of the founding team, personal characteristics of the entrepreneur, network resources of the entrepreneur, and integrity and complementarity. In the valuation stage, both investors should clarify their needs and valuation methods to achieve a more accurate valuation. In the future, more data should also be collected and different valuation models should be attempted for more in-depth analysis. For trading structures, it is necessary to improve their rationality and compatibility with investment targets, thereby boosting investor confidence to a certain extent and enhancing the competitive advantage of the product. In addition to the influencing factors we have listed, there are external factors such as the character of the business partners, the capacity of the business partners, communal benefit, etc. that have an impact on the success of the influencer. The specific principle and degree of impact need to be further studied.

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